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# GILMORE SPOKE TOO SOON: CONTRACT RISES FROM THE ASHES OF THE BAD FAITH TORT

Kerry L. Macintosh\*

"We are told that Contract, like God, is dead. And so it is," declared Professor Grant Gilmore nearly twenty years ago in his controversial book, *The Death of Contract*.<sup>1</sup>

Gilmore viewed classical contract theory as "dedicated to the proposition that, ideally, no one should be liable to anyone for anything."<sup>2</sup> "Since the ideal was not attainable," the theory sought to restrict contractual liability within the narrowest possible limits<sup>3</sup>—in part, by keeping contract damages low and by sharply differentiating them from tort damages.<sup>4</sup> But, Gilmore continued, classical contract theory had gone

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The Author was awarded the 1992 Best Writing by a Young Lawyer Award from the American College of Commercial Finance Lawyers for three of her recent writings, including, *Letters of Credit: Curbing Bad-Faith Dishonor*, 25 UCC L.J. 3 (1992); *We Have Met the Enemy and He Is Us*, 26 LOY. L.A. L. REV. 673 (1993); and this Article.—Eds.

1. GRANT GILMORE, *THE DEATH OF CONTRACT* 3 (1974).

2. *Id.* at 14.

3. *Id.*

4. *Id.* at 48. For example, consider the nineteenth-century response to *Hadley v. Baxendale*, 156 Eng. Rep. 145 (Ex. 1854). That decision established the rule that a victim of breach could recover consequential damages when the party in breach had notice of special circumstances leading to those damages. GILMORE, *supra* note 1, at 49-50. Classical scholars strongly disapproved of this aspect of *Hadley*. Mere notice was not enough, they argued; consequential damages should not be recovered unless the party in breach had deliberately assumed the risk. *Id.* at 50-52.

Ultimately, this attempt to construe *Hadley* restrictively failed. Today, damages are considered foreseeable—and therefore recoverable—if they follow as the result of special circumstances that the party in breach had reason to know. RESTATEMENT (SECOND) OF CONTRACTS § 351 (1979); see E. ALLAN FARNSWORTH, *CONTRACTS* § 12.14, at 914-15 (2d ed. 1990).

into a "protracted period of breakdown" during the twentieth century,<sup>5</sup> as evidenced by the wide range of remedies now available for breach of contract, including specific performance, punitive damages, and consequential damages.<sup>6</sup> As classical theory continued to dissolve, Gilmore concluded, contract would eventually be "reabsorbed into the mainstream of tort, . . . [the] residual category of civil liability."<sup>7</sup>

Gilmore not only declared contract dead, but also conducted an autopsy, seeking to ascertain the social, political, and historical reasons for the apparent demise of classical theory. Classical theory was born and grew during the nineteenth century at about the same time that the free market of classical economic theory was popular.<sup>8</sup> Classical theory was consistent with the narrow scope of social duty during the nineteenth century, as represented by slogans like "No man is his brother's keeper."<sup>9</sup> But during the twentieth century, Gilmore asserted, the cultural landscape changed. Human beings were no longer independent individuals, but rather, interdependent "cogs in [the] machine" of a greater society.<sup>10</sup> Thus, the death of classical contract theory reflected a more general transition from "nineteenth century individualism to the welfare state."<sup>11</sup>

This Article has two purposes. First, it asserts that, contrary to Gilmore's thesis, contract is alive and well. During the two decades since Gilmore published his book, the law has witnessed the birth, growth, and death of the "bad faith" tort—the cause of action for *tortious* breach of the covenant of good faith and fair dealing implied in every contract. Had it ever been widely accepted, the bad faith tort would have proven Gilmore's point; such acceptance would have cut the very heart out of classical contract doctrine by supplanting the traditional, limited remedies for breach of contract with the more expansive remedies of tort. Instead, the bad faith tort was the one to fall, as courts rushed to reaffirm the limited remedies that form the core of classical contract theory.

Second, this Article shows that contract stands on a sturdy policy foundation. Gilmore speculated that contract was dead because its supporting value, individualism, had been undermined by a trend towards greater social responsibility. But, as I explain, *both* individual freedom *and* social responsibility supported the rise of the bad faith tort, at the

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5. GILMORE, *supra* note 1, at 57.

6. *Id.* at 83-84.

7. *Id.* at 87.

8. *Id.* at 6-7.

9. *Id.* at 95.

10. *Id.*

11. *Id.* at 95-96.

expense of contract. More importantly, the death of the bad faith tort and the triumphant return of contract reflect the predominance of two other policy considerations that support the traditional, limited remedies for breach of contract: efficient allocation of resources and economic growth.

Part I of this Article creates a framework for analysis by describing the history of the bad faith tort. Part II begins the analysis by taking a critical look at early bad faith tort decisions. One of the most striking features of those cases was the development of a quasi-fiduciary model of contract that imposed upon the stronger contracting party the moral obligation to perform for the benefit of the weaker party. Accepting altruism as the moral foundation of the quasi-fiduciary model, I show that the rise of the bad faith tort provided temporary support for Gilmore's assertion that contract was dead—the victim of an emphasis upon social responsibility. However, later cases reaffirmed the continuing vitality of contract by retreating from the quasi-fiduciary model and rejecting the tort.

Part III reveals that early bad faith tort cases also expressed concern regarding inherent incentives to break promises within certain contractual relationships, such as insurance. Accepting individual autonomy as the policy foundation of the moral obligation to keep promises, I show that the bad faith tort vindicated freedom by deterring promise breaking. Thus, although the rise of the bad faith tort provided some support for Gilmore's claim that contract was dead, it contradicted his theory that the death of contract reflected a trend *away* from individualism. Individual autonomy and social responsibility were not enemies, but rather allies in the tort's successful opening salvos against contract. However, even with these powerful policy supporters, the tort ultimately lost the war. Recognizing that few contractual relationships presented a serious risk of promise breaking, later cases rejected the tort, thereby confirming the continuing vigor of contract.

Finally, part IV shows that early bad faith tort decisions reflected a desire to deter inefficient breach within certain contractual relationships, such as insurance. But the courts eventually realized that only a few relationships produced mostly inefficient breaches of contract. Later cases returned to traditional contract remedies, reflecting the overwhelming importance of two policies supporting such remedies: efficient allocation of resources and economic growth. As the courts rejected tort remedies for breach of contract, classical contract theory emerged a triumphant phoenix from the ashes of the dying bad faith tort.

## I. HISTORY OF THE BAD FAITH TORT

Every contract includes an implied covenant of good faith and fair dealing in its performance and enforcement.<sup>12</sup> One widely accepted theory of the implied covenant conceptualizes good faith as an "excluder," that is, a phrase without general meaning that serves to exclude a wide range of heterogeneous forms of bad faith.<sup>13</sup> Evading the spirit of the deal, slacking off, willful breach, abuse of discretion, failure to cooperate, adopting an overreaching interpretation of the contract, taking advantage of a weaker party, wrongful refusal to accept delivery, and deliberate failure to mitigate damages have all been identified as violations of the implied covenant of good faith and fair dealing.<sup>14</sup> Because it addresses such a broad range of conduct, the implied covenant has become a powerful and popular tool for policing contract performance and enforcement.<sup>15</sup>

Contract remedies are available for breach of the implied covenant of good faith and fair dealing.<sup>16</sup> Generally, these remedies provide *compensation* for damages suffered upon breach of contract.<sup>17</sup> The law seeks to make the promisee whole, rather than compel the promisor to perform its promise.<sup>18</sup> Oliver Wendell Holmes succinctly stated the philosophy behind contract remedies:

The only universal consequence of a legally binding promise is, that the law makes the promisor pay damages if the promised event does not come to pass. In every case it leaves him free

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12. See RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979); FARNSWORTH, *supra* note 4, § 7.17, at 526.

13. See Robert S. Summers, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 197 (1968). An examination of the meaning of good faith is beyond the scope of this Article. I have chosen to work with the Summers theory due to its wide acceptance within the legal community. See RESTATEMENT (SECOND) OF CONTRACTS § 205 & cmt. a.

For competing theories of the good faith obligation, see Eric G. Andersen, *Good Faith in the Enforcement of Contracts*, 73 IOWA L. REV. 299 (1988); Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980); Russell A. Eisenberg, *Good Faith Under the Uniform Commercial Code—A New Look at an Old Problem*, 54 MARQ. L. REV. 1 (1971); and B.J. Reiter, *Good Faith in Contracts*, 17 VAL. U. L. REV. 705 (1983).

14. See Summers, *supra* note 13, at 232-33, 243, 248.

15. See *id.* at 198-99.

16. See, e.g., *Foley v. Interactive Data Corp.*, 47 Cal. 3d 654, 684, 765 P.2d 373, 389, 254 Cal. Rptr. 211, 227 (1988).

17. *Id.* at 683, 765 P.2d at 389, 254 Cal. Rptr. at 227.

18. See FARNSWORTH, *supra* note 4, § 12.1, at 840.

from interference until the time for fulfillment has gone by, and therefore free to break his contract if he chooses.<sup>19</sup>

Since contract remedies have compensation—rather than punishment—as a goal, it comes as no surprise that punitive damages are not ordinarily available for breach of contract, even in cases where breach is deliberate or aggravated.<sup>20</sup> Based solely on those goals one might assume that punitive damages could never be recovered for breach of the implied covenant of good faith and fair dealing.

However, in the 1960s the implied covenant of good faith and fair dealing began its now celebrated metamorphosis from an implied covenant actionable in contract, to a *duty* actionable in tort. The stage for this dramatic development was the insurance industry.

### A. Birth of the Bad Faith Tort

In the leading case of *Crisci v. Security Insurance Co.*,<sup>21</sup> a tenant sued her landlady, Rosina Crisci, for personal injuries allegedly resulting from an accident suffered on the premises of her apartment building.<sup>22</sup> Crisci had \$10,000 of insurance coverage under a general liability policy issued by Security Insurance Company (Security).<sup>23</sup> This policy obligated Security to defend the suit against Crisci and make any settlement deemed expedient.<sup>24</sup> However, Security rejected offers to settle the third-party claim within policy limits.<sup>25</sup> When a jury returned a verdict against Crisci for \$101,000, Security paid the policy limit of \$10,000, leaving Crisci to make up the balance.<sup>26</sup> Left indigent and seriously depressed, Crisci eventually sued Security for wrongful failure to settle the claim against her.<sup>27</sup> The trial court awarded Crisci the balance of the

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19. OLIVER WENDELL HOLMES, *THE COMMON LAW* 236 (Mark D. Howe ed., Harvard Univ. Press 1963) (1881).

20. E. Allan Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145, 1146 (1970).

21. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

22. *Id.* at 427, 426 P.2d at 175, 58 Cal. Rptr. at 15.

23. *Id.* at 428, 426 P.2d at 175, 58 Cal. Rptr. at 15.

24. *Id.*

25. *Id.* As the facts of *Crisci* suggest, the phrase “third-party claim” refers to a claim that a third party—that is, someone *outside* the contractual relationship between insured and insurer—brings against the insured. See, e.g., STEPHEN S. ASHLEY, *BAD FAITH ACTIONS—LIABILITY AND DAMAGES* § 1.06 (1992) (explaining that traditional liability coverage indemnifies insured against claims by persons not parties to insurance contract).

26. *Crisci*, 66 Cal. 2d at 428-29, 426 P.2d at 176, 58 Cal. Rptr. at 16.

27. *Id.* at 429, 426 P.2d at 176, 58 Cal. Rptr. at 16.

judgment against her, \$91,000, plus \$25,000 for mental suffering.<sup>28</sup> Security appealed to the California Supreme Court.

At the time of Security's appeal, failure to settle a third-party claim within policy limits in an appropriate case already constituted a breach of the implied covenant of good faith and fair dealing, which was actionable in contract.<sup>29</sup> But the California Supreme Court went even further in *Crisci*, proclaiming that the action for breach of the implied covenant sounded not only in contract, but also in tort.<sup>30</sup> "Liability is imposed not for a bad faith breach of the contract but for failure to meet the duty to accept reasonable settlements, a duty included within the implied covenant of good faith and fair dealing," the court stated.<sup>31</sup> Concluding that sufficient evidence existed to support the determination that Security had breached this duty, the court affirmed the judgment in favor of *Crisci*.<sup>32</sup>

Similarly, in *Gruenberg v. Aetna Insurance Co.*,<sup>33</sup> the owner of a fire-damaged bar and restaurant sued his three fire insurance companies for tortious breach of the implied duty of good faith and fair dealing.<sup>34</sup> According to the owner, the companies had falsely implied to authorities that he had a motive to commit arson in order to establish grounds for refusing to pay the amounts due under the policies.<sup>35</sup> The trial court sustained demurrers to the complaint and the owner appealed.<sup>36</sup> Extending the bad faith tort to include first-party claims,<sup>37</sup> the California Supreme Court held that an insurer could tortiously breach its good faith duty by unreasonably refusing to compensate its own insured for a loss covered by its policy.<sup>38</sup> Concluding that the owner's complaint was sufficient to allege tortious breach of the good faith duty, the court overruled the demurrers as to the insurance companies.<sup>39</sup>

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28. *Id.* at 427, 426 P.2d at 175, 58 Cal. Rptr. at 15.

29. *See, e.g., Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 661, 328 P.2d 198, 202 (1958).

30. *Crisci*, 66 Cal. 2d at 432, 426 P.2d at 178, 58 Cal. Rptr. at 18.

31. *Id.* at 430, 426 P.2d at 177, 58 Cal. Rptr. at 17.

32. *Id.* at 431-32, 426 P.2d at 177-78, 58 Cal. Rptr. at 17-18.

33. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

34. *Id.* at 570, 510 P.2d at 1034, 108 Cal. Rptr. at 482.

35. *Id.* at 571-72, 510 P.2d at 1035, 108 Cal. Rptr. at 483.

36. *Id.* at 570-72, 510 P.2d at 1034-36, 108 Cal. Rptr. at 482-84.

37. As the facts of *Gruenberg* suggest, the phrase "first-party claim" refers to an insured's claim against his or her insurer for compensation under his or her own insurance policy. *See, e.g., ASHLEY, supra* note 25, § 1.07 (explaining that insurance policies that cover first-party claims include homeowners, health, life, and disability policies).

38. *Gruenberg*, 9 Cal. 3d at 573-74, 510 P.2d at 1037, 108 Cal. Rptr. at 484.

39. *Id.* at 575, 510 P.2d at 1038, 108 Cal. Rptr. at 486.

Although both *Crisci* and *Gruenberg* were quickly followed by courts in several other jurisdictions,<sup>40</sup> neither case explained why breach of the implied covenant of good faith and fair dealing should, in the insurance context, sound in tort as well as contract.<sup>41</sup> This omission is particularly disappointing given the significant differences in contract and tort policy objectives. Contract remedies provide compensation; tort remedies provide compensation *and* serve a deterrent and retributive function.<sup>42</sup> Tort liability encourages potential defendants to prevent the

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40. Most jurisdictions have recognized a bad faith tort for failure to settle a third-party claim against the insured. *See, e.g.,* *Fireman's Fund Ins. Co. v. Security Ins. Co.*, 367 A.2d 864, 867 (N.J. 1976); *Gordon v. Nationwide Mut. Ins. Co.*, 285 N.E.2d 849, 854 (N.Y. 1972), *cert. denied*, 410 U.S. 931 (1973).

Several jurisdictions have followed California's lead in extending the bad faith tort to include unreasonable denial of the insured's first-party claim against the insurer. *See, e.g.,* *State Farm Fire & Casualty Co. v. Nicholson*, 777 P.2d 1152, 1156-57 (Alaska 1989); *Anderson v. Continental Ins. Co.*, 271 N.W.2d 368, 375-76 (Wis. 1978). *But see* *Kewin v. Massachusetts Mut. Life Ins. Co.*, 295 N.W.2d 50, 56 (Mich. 1980); *Beck v. Farmers Ins. Exch.*, 701 P.2d 795, 800 (Utah 1985).

41. The *Crisci* court emphasized that the insured had entered into the insurance contract, not to obtain a commercial advantage, but rather to obtain peace of mind and security in the event of an accidental loss. *Crisci*, 66 Cal. 2d at 434, 426 P.2d at 179, 58 Cal. Rptr. at 19. However, the court advanced this purpose not to explain why bad faith conduct was tortious, but to explain why damages for mental suffering were appropriate in that case. *Id.*

Similarly, in the later case of *Egan v. Mutual of Omaha Ins.*, 24 Cal. 3d 809, 620 P.2d 141, 169 Cal. Rptr. Supp. 691 (1979), *cert. denied and appeal dismissed*, 445 U.S. 912 (1980), the California Supreme Court emphasized that the insured had purchased disability insurance to provide peace of mind and security in the event he was unable to work. Again, however, this purpose was advanced to explain why failure to investigate the insured's claim constituted a breach of the implied covenant, and not why breach of the implied covenant sounded in tort. *Id.* at 818-19, 620 P.2d at 145-46, 169 Cal. Rptr. Supp. at 695-96.

The *Egan* court also noted that the insurer and insured enjoyed a "special relationship." *Id.* at 820, 620 P.2d at 146, 169 Cal. Rptr. Supp. at 696. The court explained that, because the insurer was supplying a service affecting the public interest, its obligation of good faith and fair dealing included "qualities of decency and humanity inherent in the responsibilities of a fiduciary." *Id.* (citation omitted). Moreover, the relationship of insurer and insured was inherently unbalanced due to the "adhesive nature of insurance contracts." *Id.* The only purpose of this discussion, however, was to justify an award of punitive damages under California statutory law. *See id.*, 620 P.2d at 146, 169 Cal. Rptr. Supp. at 696-97. Some years later, the California Supreme Court recharacterized its own reasoning in *Egan* as describing some of the bases for permitting tort recovery for breach of the implied covenant in the insurance context. *See* *Foley v. Interactive Data Corp.*, 47 Cal. 3d 654, 684-85, 765 P.2d 373, 390, 254 Cal. Rptr. 211, 228-29 (1988).

42. Some scholars have suggested that contract damages can also serve to deter and punish breach of contract. "[C]ontract damages not only compensate for pecuniary loss, but also operate as a substitute for personal vengeance and act to deter other contract breaches." Timothy J. Sullivan, *Punitive Damages in the Law of Contract: The Reality and the Illusion of Legal Change*, 61 MINN. L. REV. 207, 219 (1977) (footnote omitted); *see also* 5 ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 1002, at 33-35 (1964) (discussing rules of law policy providing for breach of contract damages). However, while contract damages may have the effect of deterring or punishing some breaches of contract, they are not *designed* to achieve these



occurrence of harm and punishes wrongdoers for their violation of community norms.<sup>43</sup> These twin goals—deterrence and retribution—are most clearly reflected in the availability of punitive damages for tortious conduct.<sup>44</sup> Although punitive damages cannot be recovered for breach of contract,<sup>45</sup> they can be awarded in tort for conduct that is outrageous because of the defendant's evil motive or reckless indifference to the rights of others.<sup>46</sup> Thus, by developing the bad faith tort to redress outrageous behavior within a contractual relationship, the courts opened the door to recovery of punitive damages—an opportunity that plaintiffs did not ignore.

The next important application of the bad faith tort involved the employment arena. In 1980 the California Court of Appeal decided *Cleary v. American Airlines*.<sup>47</sup> There, an employer discharged an employee after eighteen years of service, allegedly as retaliation for participation in union activities.<sup>48</sup> The employee sued, asserting inter alia a claim for breach of the implied covenant of good faith and fair dealing.<sup>49</sup> The trial court dismissed for failure to state a claim,<sup>50</sup> but the court of appeal reversed, holding that the employee had pleaded a viable cause of action.<sup>51</sup> The court reasoned that, given the length of the employee's service and the employer's failure to follow its own procedures for adjudicating employee disputes, termination without legal cause constituted a breach of the implied covenant of good faith and fair dealing.<sup>52</sup> Citing to insurance cases such as *Gruenberg*, but without engaging in any comparative analysis of insurance and employment relationships, the *Cleary* court concluded that the employee's claim sounded in both contract and tort.<sup>53</sup> Once *Cleary* was decided, the California Court of Appeal issued

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ends. See Farnsworth, *supra* note 20, at 1146. Thus, it is reasonable to characterize compensation as the primary objective of contract remedies.

43. See RESTATEMENT (SECOND) OF TORTS § 901 cmt. c (1977); W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 4, at 25-26 (5th ed. 1984).

44. See RESTATEMENT (SECOND) OF TORTS § 908(1); KEETON ET AL., *supra* note 43, § 2, at 9.

45. RESTATEMENT (SECOND) OF CONTRACTS § 355 (1979); see FARNSWORTH, *supra* note 4, § 12.8, at 874.

46. RESTATEMENT (SECOND) OF TORTS § 908(2); KEETON ET AL., *supra* note 43, § 2, at 9-10.

47. 111 Cal. App. 3d 443, 168 Cal. Rptr. 722 (1980).

48. *Id.* at 447, 168 Cal. Rptr. at 724.

49. *Id.*

50. *Id.* at 454, 168 Cal. Rptr. at 729.

51. *Id.* at 456-57, 168 Cal. Rptr. at 730.

52. *Id.* at 455, 168 Cal. Rptr. at 729.

53. *Id.* at 456, 168 Cal. Rptr. at 729-30.

other decisions recognizing the bad faith tort in the employment context.<sup>54</sup>

While some states, such as Montana and Nevada, joined California in recognizing the bad faith tort in the employment context,<sup>55</sup> others refused to do so.<sup>56</sup> For example, in *Martin v. Federal Life Insurance Co.*,<sup>57</sup> an employee sued for damages allegedly caused by his wrongful discharge, asserting inter alia a claim for tortious breach of the implied covenant of good faith and fair dealing.<sup>58</sup> The trial court dismissed this claim for failure to state a cause of action, and the Illinois Appellate Court affirmed, holding that Illinois law did not recognize a tort remedy based on an employer's bad faith breach of the implied covenant.<sup>59</sup> The court reasoned that "[c]are must be taken to prevent the transmutation of every breach of contract into an independent tort action through the bootstrapping of the general contract principle of good faith and fair dealing."<sup>60</sup>

Judicial enthusiasm for the bad faith tort reached new heights in 1984, when the California Supreme Court issued its decision in *Seaman's Direct Buying Service v. Standard Oil Co.*<sup>61</sup> Seaman's, a ship supply dealer, wanted to lease part of a marina from the City of Eureka.<sup>62</sup> Realizing that approval of the lease depended on its ability to operate a marine fuel dealership with modernized fueling equipment, Seaman's entered into an agreement with Standard, a major oil company, for the supply of its fuel requirements.<sup>63</sup> The city granted the lease.<sup>64</sup> Shortly thereafter, an oil shortage developed and the federal government issued regulations requiring suppliers to continue providing fuel to existing cus-

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54. See, e.g., *Khanna v. Microdata Corp.*, 170 Cal. App. 3d 250, 262, 215 Cal. Rptr. 860, 867 (1985); see also *Hannon Eng'g v. Reim*, 126 Cal. App. 3d 415, 427, 179 Cal. Rptr. 78, 84 (1981) (holding that once relationship between employee and employer matures into relationship between pensioner and trustee of pension fund, breach of duty of good faith and fair dealing sounds in tort).

55. See *Dare v. Montana Petroleum Mktg. Co.*, 687 P.2d 1015, 1020 (Mont. 1984); *Gates v. Life of Mont. Ins. Co.*, 668 P.2d 213, 215 (Mont. 1983); *K Mart Corp. v. Ponsock*, 732 P.2d 1364, 1370-73 (Nev. 1987).

56. See, e.g., *Arco Alaska, Inc. v. Akers*, 753 P.2d 1150, 1153-54 (Alaska 1988); *Wagenseiler v. Scottsdale Memorial Hosp.*, 710 P.2d 1025, 1038-40 (Ariz. 1985); *Martin v. Federal Life Ins. Co.*, 440 N.E.2d 998, 1006 (Ill. App. Ct. 1982).

57. 440 N.E.2d 998 (Ill. App. Ct. 1982).

58. *Id.* at 1006.

59. *Id.*

60. *Id.*

61. 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984).

62. *Id.* at 759, 686 P.2d at 1160, 206 Cal. Rptr. at 356.

63. *Id.* at 759-60, 686 P.2d at 1160, 206 Cal. Rptr. at 356.

64. *Id.* at 760, 686 P.2d at 1161, 206 Cal. Rptr. at 357.

tomers.<sup>65</sup> Considering itself such a customer, Seaman's applied to the responsible federal agency for an order directing Standard to continue providing fuel to Seaman's.<sup>66</sup> Following a series of decisions and appeals, the agency decreed that a supply order would be issued when Seaman's produced a court decree stating that a valid contract existed between it and Standard.<sup>67</sup> Seaman's asked Standard to stipulate to the existence of a contract because it could not survive without fuel throughout a lengthy trial.<sup>68</sup> Standard's representative laughed and said, "'See you in court.'"<sup>69</sup> Forced to discontinue its operations, Seaman's asserted several claims against Standard, including a claim for tortious breach of the implied covenant of good faith and fair dealing.<sup>70</sup> The jury returned a verdict for Seaman's on the bad faith tort claim,<sup>71</sup> but the court of appeal reversed the judgment.<sup>72</sup> Standard appealed from the judgment and Seaman's filed a cross-appeal.<sup>73</sup>

As the California Supreme Court recognized, the major issue raised by the appeal was whether breach of the implied covenant of good faith and fair dealing in a *commercial* contract could give rise to an action in tort.<sup>74</sup> A tort action was available for breach of the covenant in an insurance contract, the court emphasized, because there was a "special relationship between insurer and insured, characterized by elements of public interest, adhesion, and fiduciary responsibility."<sup>75</sup> No doubt there were similar relationships deserving similar legal treatment. However, courts must be careful when deciding whether or not to apply tort remedies in a commercial context.

When we move from such special relationships to consideration of the tort remedy in the context of the ordinary commercial contract, we move into largely uncharted and potentially dangerous waters. Here, parties of roughly equal

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65. *Id.* at 760-61, 686 P.2d at 1161, 206 Cal. Rptr. at 357.

66. *Id.* at 761, 686 P.2d at 1161, 206 Cal. Rptr. at 357.

67. *Id.*, 686 P.2d at 1162, 206 Cal. Rptr. at 358.

68. *Id.* at 761-62, 686 P.2d at 1162, 206 Cal. Rptr. at 358.

69. *Id.* at 762, 686 P.2d at 1162, 206 Cal. Rptr. at 358.

70. *Id.*

71. *Id.* In order to fend off the oil company's motion for a new trial, Seaman's later consented to the reduction of these punitive damages to one million dollars. *Id.*

72. *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 129 Cal. App. 3d 416, 181 Cal. Rptr. 126 (1982), *vacated*, 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984).

73. *Seaman's Direct Buying Serv.*, 36 Cal. 3d at 762, 686 P.2d at 1162, 206 Cal. Rptr. at 358.

74. *Id.* at 767, 686 P.2d at 1166, 206 Cal. Rptr. at 362.

75. *Id.* at 768-69, 686 P.2d at 1166, 206 Cal. Rptr. at 362 (citing *Egan v. Mutual of Omaha Ins.*, 24 Cal. 3d 809, 820, 620 P.2d 141, 146, 169 Cal. Rptr. Supp. 691, 696 (1979), *cert. denied and appeal dismissed*, 445 U.S. 912 (1980)).

bargaining power are free to shape the contours of their agreement . . . . In such contracts, it may be difficult to distinguish between breach of the covenant and breach of contract, and there is the risk that interjecting tort remedies will intrude upon the expectations of the parties. This is not to say that tort remedies have no place in such a commercial context, but that it is wise to proceed with caution in determining their scope and application.<sup>76</sup>

Proceeding with such caution, the court refused to address the broad question of whether a breach of the implied covenant of good faith and fair dealing in a commercial contract sounded in tort, reasoning that it was not even necessary to base liability upon a breach of the implied covenant as such.<sup>77</sup> It was enough to recognize that a party could incur tort remedies when, in addition to breaching a contract, it sought to "shield itself from liability by denying, in bad faith and without probable cause, that the contract exist[ed]."<sup>78</sup> "Such conduct goes beyond the mere breach of contract," the court opined.<sup>79</sup> "It offends accepted notions of business ethics."<sup>80</sup> In such a situation, the court continued, "[a]cceptance of tort remedies [was] not likely to intrude upon the bargaining relationship or upset reasonable expectations [sic] of the contracting parties."<sup>81</sup> Concluding that the trial court had failed to properly instruct the jury regarding the necessity of bad faith denial, the court reversed the judgment for Seaman's on the bad faith tort claim and remanded for further proceedings.<sup>82</sup>

The legal community was not persuaded by the California Supreme Court's protestations regarding the limited nature of its holding in *Seaman's*. As one commentator noted, bad faith denial of the existence of a contract was simply a form of the tortious breach of the implied covenant of good faith and fair dealing, and not a separate tort.<sup>83</sup> Moreover, there was little difference between bad faith denial of the existence of a contract and bad faith assertion of any other defense to liability. Thus, with little effort, a plaintiff could use the reasoning in *Seaman's* to recast vir-

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76. *Id.* at 769, 686 P.2d at 1166-67, 206 Cal. Rptr. at 362-63.

77. *Id.*, 686 P.2d at 1167, 206 Cal. Rptr. at 363.

78. *Id.*

79. *Id.* at 770, 686 P.2d at 1167, 206 Cal. Rptr. at 363.

80. *Id.* (citing *Jones v. Abriani*, 350 N.E.2d 635 (Ind. 1976)).

81. *Id.*

82. *Id.* at 774, 686 P.2d at 1170, 206 Cal. Rptr. at 366.

83. See Eileen A. Scallen, Comment, *Sailing the Uncharted Seas of Bad Faith: Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*, 69 MINN. L. REV. 1161, 1165-76 (1985).

tually any contested breach of contract as a tort.<sup>84</sup> Not surprisingly then, despite its seemingly narrow holding, the *Seaman's* decision fueled widespread speculation that the courts might soon extend the claim for tortious breach of the duty of good faith and fair dealing to the commercial context, thereby eliminating the line between breach of contract and tort.<sup>85</sup>

In fact, California courts quickly seized upon the dictum in *Seaman's* that the bad faith tort could properly be applied where there was a special relationship comparable to that between insurer and insured. One of the most influential of these post-*Seaman's* cases was *Wallis v. Superior Court*.<sup>86</sup> In that case, a fifty-five-year-old employee learned that his employer planned to close the furniture manufacturing plant where he worked.<sup>87</sup> Before he left the company, he entered into a contract with his employer, exchanging his promise not to compete for the employer's promise to pay him a monthly stipend until he reached age sixty-five and could begin drawing his accrued pension benefits.<sup>88</sup> The employer then closed the plant and the employee was laid off.<sup>89</sup> For three years, the employer made the payments.<sup>90</sup> However, when business took a turn for the worse, it sent the employee a letter, stating that the "gratuitous" payments would be terminated.<sup>91</sup> The employee sued, asserting inter alia a claim for tortious breach of the duty of good faith and fair dealing.<sup>92</sup> When the trial court sustained the employer's demurrer to this claim, the employee appealed.<sup>93</sup>

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84. See C. Delos Putz, Jr. & Nona Klippen, *Commercial Bad Faith: Attorney Fees—Not Tort Liability—Is the Remedy for "Stonewalling"*, 21 U.S.F. L. REV. 419, 459 (1987); Michael Traynor, *Bad Faith Breach of a Commercial Contract: A Comment on the Seaman's Case*, 8 BUS. L. NEWS 1, 11 (1984); Sandra Chutorian, Note, *Tort Remedies for Breach of Contract: The Expansion of Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing into the Commercial Realm*, 86 COLUM. L. REV. 377, 401 (1986).

85. See, e.g., Werner F. Ebke & James R. Griffin, *Good Faith and Fair Dealing in Commercial Lending Transactions: From Covenant to Duty and Beyond*, 49 OHIO ST. L.J. 1237, 1237-38 (1989); Putz & Klippen, *supra* note 84, at 419; Raymone Wallenstein, *Breach of the Implied Covenant of Good Faith and Fair Dealing in Commercial Contracts: A Wrong in Search of a Remedy*, 20 U. WEST L.A. L. REV. 113 (1989); Jill P. Anderson, Note, *Lender Liability for Breach of the Obligation of Good Faith Performance*, 36 EMORY L.J. 917, 957-66 (1987); Brad Schacht, Note, *Bad Faith Lenders*, 60 U. COLO. L. REV. 417 (1989).

86. 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984).

87. *Id.* at 1113, 207 Cal. Rptr. at 125.

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.*

93. *Id.* at 1113-14, 207 Cal. Rptr. at 125-26.

To determine whether the employee had stated a valid cause of action, the California Court of Appeal scrutinized the insurance relationship.<sup>94</sup> It identified five characteristics of a special relationship sufficient to justify imposition of tort liability for breach of the duty of good faith and fair dealing.<sup>95</sup> The importance of these characteristics to subsequent analysis requires their enumeration here:

- (1) [T]he contract must be such that the parties are in inherently unequal bargaining positions; (2) the motivation for entering the contract must be a nonprofit motivation, i.e., to secure peace of mind, security, future protection; (3) ordinary contract damages are not adequate, because (a) they do not require the party in the superior position to account for its actions, and (b) they do not make the inferior party "whole"; (4) one party is especially vulnerable because of the type of harm it may suffer and of necessity places trust in the other party to perform; and (5) the other party is aware of this vulnerability.<sup>96</sup>

Applying this five-part test to the facts before it, the *Wallis* court found that the employee and employer enjoyed such a special relationship. First, the parties were in inherently unequal bargaining positions because the employee needed money and had few skills outside the furniture manufacturing area.<sup>97</sup> Second, the employee entered into the contract to obtain financial security and peace of mind.<sup>98</sup> Third, ordinary contract damages were not adequate because they offered no incentive for the employer not to breach; if the employee obtained a judgment for mere breach of contract, the employer would only have to pay what it owed anyway.<sup>99</sup> Contract damages were inadequate for another reason: The employee's immediate precarious financial position due to termination of payments could not be remedied by a lump-sum payment received several years later.<sup>100</sup> Fourth, the employee was in an extremely vulnerable position because of his age, lack of other work skills, and financial responsibilities. Finally, the employer was aware of the employee's vulnerable position.<sup>101</sup> Since there was a special relationship between the parties, the court concluded, the employee had stated a valid claim for

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94. *Id.* at 1116-19, 207 Cal. Rptr. at 127-30.

95. *Id.* at 1118, 207 Cal. Rptr. at 129.

96. *Id.*

97. *Id.* at 1119, 207 Cal. Rptr. at 129.

98. *Id.*

99. *Id.*

100. *Id.*

101. *Id.*

tortious breach of the implied covenant of good faith and fair dealing, and the employer's demurrer must be overruled.<sup>102</sup>

The California Court of Appeal used the special relationship theory to extend tort liability still further when it decided *Commercial Cotton Co. v. United California Bank*.<sup>103</sup> That case involved a bank and a depositor that maintained a commercial checking account with the bank.<sup>104</sup> Having negligently charged the depositor's account for a forged check, the bank refused to recredit the account, asserting as a defense a statute of limitations that bank counsel knew was inapplicable.<sup>105</sup> At trial the depositor was awarded \$100,000 in punitive damages on its claim for tortious breach of the duty of good faith and fair dealing.<sup>106</sup> The court of appeal affirmed, holding that the relationship between bank and depositor was at least "quasi-fiduciary."<sup>107</sup> Thus, the depositor could reasonably expect the bank not to raise nonexistent legal defenses after negligently disbursing entrusted funds.<sup>108</sup>

*Commercial Cotton* represented the high-water mark in the history of the bad faith tort in California. Until that decision the relationship between depositor and bank was considered to be at arm's length, with the depositor acting as creditor and the bank as debtor to the extent of the deposited funds.<sup>109</sup> The sudden characterization of the depositor-bank relationship as "quasi-fiduciary" ran directly counter to the well-established rule that a debtor-creditor relationship was not fiduciary,<sup>110</sup> and sent shock waves throughout the commercial world.<sup>111</sup>

While California boldly went where no court had gone before, other states continued to demonstrate little enthusiasm for the bad faith tort. Oklahoma refused to recognize the tort in the commercial lending con-

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102. *Id.*, 207 Cal. Rptr. at 129-30.

103. 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985).

104. *Id.* at 514, 209 Cal. Rptr. at 553.

105. *Id.* at 514-15, 209 Cal. Rptr. at 553.

106. *Id.* at 511, 209 Cal. Rptr. at 551-52.

107. *Id.* at 516, 209 Cal. Rptr. at 554.

108. *Id.*

109. See, e.g., *Morse v. Crocker Nat'l Bank*, 142 Cal. App. 3d 228, 232, 190 Cal. Rptr. 839, 842 (1983); *Peterson v. Idaho First Nat'l Bank*, 367 P.2d 284, 288 (Idaho 1961).

110. See 1 AUSTIN W. SCOTT & WILLIAM F. FRATCHER, *THE LAW OF TRUSTS* § 12.1 (4th ed. 1987).

111. See, e.g., N.E. Bettsworth, Note, *Commercial Cotton Co. v. United California Bank: California's Newest Extension of Bad Faith Litigation into Commercial Law*, 16 Sw. U. L. REV. 645 (1986); Kenneth W. Curtis, Comment, *The Fiduciary Controversy: Injection of Fiduciary Principles into the Bank-Depositor and Bank-Borrower Relationships*, 20 LOY. L.A. L. REV. 795 (1987).

text,<sup>112</sup> as did Nevada in the commercial leasing context.<sup>113</sup> Alabama and Arizona rejected tort remedies for bad faith breach of contracts for the sale of goods and real estate, respectively.<sup>114</sup> Only Montana continued to follow California's lead, extending the tort to deposit<sup>115</sup> and loan<sup>116</sup> contracts.

Eventually, Montana took the leap that even California had been unwilling to take, extending the tort to commercial contracts unsullied by any hint of a special relationship. In *Nicholson v. United Pacific Insurance Co.*,<sup>117</sup> a commercial lessor alleged that the lessee had rescinded the lease agreement without justification and in tortious breach of the duty of good faith and fair dealing.<sup>118</sup> The jury returned a verdict for the lessor, and the lessee appealed.<sup>119</sup> The Montana Supreme Court affirmed, holding that one party could assert a bad faith tort claim whenever the other party frustrated its justifiable expectations under the contract by acting arbitrarily, capriciously, or unreasonably.<sup>120</sup> Montana cases following *Nicholson* recognized claims for tortious breach of a commercial franchise agreement<sup>121</sup> and of a contract for the sale of a business.<sup>122</sup>

### B. *The Death of the Bad Faith Tort*

Meanwhile, the winds of political change had begun to blow. As early as 1978 Californians responded to a frightening increase in violent crime by passing an initiative imposing the death penalty for certain homicides.<sup>123</sup> But the California Supreme Court, headed by Chief Justice Rose Bird, persistently overturned nearly all death verdicts.<sup>124</sup> In

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112. See *Rodgers v. Tecumseh Bank*, 756 P.2d 1223, 1226-27 (Okla. 1988).

113. See *Aluevich v. Harrah's*, 660 P.2d 986, 987 (Nev. 1983), *cert. denied*, 465 U.S. 1006 (1984).

114. See *Kennedy Elec. Co. v. Moore-Handley, Inc.*, 437 So. 2d 76, 81 (Ala. 1983); *Oldenburger v. Del E. Webb Dev. Co.*, 765 P.2d 531, 535 (Ariz. Ct. App. 1988).

115. *Tribby v. Northwestern Bank*, 704 P.2d 409, 419 (Mont. 1985).

116. See *First Nat'l Bank v. Twombly*, 689 P.2d 1226, 1230 (Mont. 1984).

117. 710 P.2d 1342 (Mont. 1985).

118. *Id.* at 1343.

119. *Id.*

120. *Id.* at 1348.

121. See *Dunfee v. Baskin-Robbins, Inc.*, 720 P.2d 1148, 1153 (Mont. 1986).

122. See *McGregor v. Mommer*, 714 P.2d 536, 543 (Mont. 1986).

123. See CAL. PENAL CODE § 190.2 (West 1988). A 72% majority of the electorate passed the initiative. Ed Salzman, *Election '78 Post-Mortem*, 9 CAL. J. 386, 390 (1978); see also Howard J. Schwab, *The History of the Death Penalty in California*, L.A. LAW., Sept. 1981, at 8, 13.

124. From 1979 through 1986 the California Supreme Court reviewed 64 death verdicts, affirming only five (7.8%). Gerald F. Uelman, *Review of Death Penalty Judgments by the Supreme Courts of California: A Tale of Two Courts*, 23 LOY. L.A. L. REV. 237, 237 (1989).



1986, angered by this apparent refusal to carry out the popular will, the public voted Chief Justice Bird and two other justices out of office.<sup>125</sup> In 1987 then-Governor George Dukemejian, an avowed conservative, appointed three new justices as replacements and elevated fellow conservative Justice Malcom Lucas to the position of Chief Justice.<sup>126</sup>

This change in court membership had the desired effect: The California Supreme Court immediately began to affirm most death verdicts.<sup>127</sup> But the change in court membership had another, perhaps unintended, effect: California's enthusiasm for the bad faith tort began to subside.

The pivotal case was *Foley v. Interactive Data Corp.*,<sup>128</sup> decided in 1988. In that case a terminated employee sued his former employer, alleging tortious breach of the implied covenant of good faith and fair dealing.<sup>129</sup> The trial court sustained a demurrer without leave to amend, the court of appeal affirmed, and the employee appealed to the California Supreme Court.<sup>130</sup>

The California Supreme Court began its opinion by emphasizing the traditional distinction between contract and tort.<sup>131</sup> The court reasoned that the original purpose of the implied covenant of good faith was to protect the express covenants or promises of the contract, not to effectuate some general public policy.<sup>132</sup> Thus, cases recognizing a claim for tortious breach of the implied covenant in the insurance context represented a major departure from traditional contract principles.<sup>133</sup> Further extensions of the exceptional approach taken in those cases must be considered with great care.<sup>134</sup>

The court, assuming *arguendo* that the special relationship model was the correct one to follow in deciding whether to extend tort remedies, proceeded to compare the insurance and employment relationships.<sup>135</sup> The court made three distinctions. First, since no other insurer will cover a loss once incurred, bad faith denial of coverage forces the insured to bear the entire loss. By contrast, a wrongfully terminated em-

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125. *See id.* at 238.

126. *Id.*

127. From 1987 through March 1989 the California Supreme Court reviewed 71 death verdicts, affirming 51 verdicts (71.8%). *Id.* at 237.

128. 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211 (1988).

129. *Id.* at 662, 765 P.2d at 374, 254 Cal. Rptr. at 212.

130. *Id.*

131. *Id.* at 682-83, 765 P.2d at 389, 254 Cal. Rptr. at 227.

132. *Id.* at 690, 765 P.2d at 394, 254 Cal. Rptr. at 232.

133. *Id.*

134. *Id.*

135. *Id.* at 692, 765 P.2d at 395-96, 254 Cal. Rptr. at 234.

ployee can mitigate its loss by seeking alternative employment.<sup>136</sup> Second, an insurer provides a quasi-public service by selling protection against potential economic loss to individuals seeking financial security. In contrast, "[t]he employer does not similarly 'sell' protection to its employees; it is not providing a public service. Nor do we find convincing the idea that the employee is necessarily seeking a different kind of financial security than those entering a typical commercial contract."<sup>137</sup> Finally, in the insurance context the insurer and insured are financially at odds, since payment of a claim shifts money from the insurer to the insured or a third-party claimant.<sup>138</sup> In contrast, the interests of the employer and employee are generally aligned, since it is in the employer's interest to retain the employee.<sup>139</sup>

Thus, the court concluded, the employment relationship was not sufficiently similar to that between insurer and insured to warrant extension of tort remedies, particularly in light of countervailing concerns about economic policy and stability, the traditional separation of tort and contract law, and numerous protections against improper terminations already afforded employees.<sup>140</sup> Breach of the implied covenant of good faith and fair dealing in an employment contract did not sound in tort.<sup>141</sup>

After *Foley* lower California courts quickly moved to limit the bad faith tort, holding that it did not apply to commercial lending<sup>142</sup> or dealership<sup>143</sup> contracts. Significantly, the California Court of Appeal expressly repudiated its earlier decision in *Commercial Cotton*, holding that the bank-depositor relationship was not quasi-fiduciary, and did not give rise to tort damages when an implied covenant of good faith was broken.<sup>144</sup>

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136. *Id.*, 765 P.2d at 396, 254 Cal. Rptr. at 234.

137. *Id.*

138. *Id.* at 693, 765 P.2d at 396, 254 Cal. Rptr. at 234.

139. *Id.*

140. *Id.*, 765 P.2d at 396, 254 Cal. Rptr. at 234-35.

141. *Id.* at 700, 765 P.2d at 401, 254 Cal. Rptr. at 239-40.

142. See *Careau & Co. v. Security Pac. Business Credit, Inc.*, 222 Cal. App. 3d 1371, 1400, 272 Cal. Rptr. 387, 403 (1990); *Price v. Wells Fargo Bank*, 213 Cal. App. 3d 465, 478, 261 Cal. Rptr. 735, 741 (1989); *Mitsui Mfrs. Bank v. Superior Court*, 212 Cal. App. 3d 726, 731-32, 260 Cal. Rptr. 793, 796-97 (1989).

143. See *Martin v. U-Haul Co.*, 204 Cal. App. 3d 396, 415, 251 Cal. Rptr. 17, 28 (1988); see also *Premier Wine & Spirits v. E. & J. Gallo Winery*, 644 F. Supp. 1431, 1439 (E.D. Cal. 1986) (holding no special relationship between wine distributor and supplier that would support bad faith tort claim for termination of distributorship), *aff'd*, 846 F.2d 537 (9th Cir. 1988).

144. *Copesky v. Superior Court*, 229 Cal. App. 3d 678, 694, 280 Cal. Rptr. 338, 348 (1991) ("Since appending the quasi-fiduciary label to the ordinary bank-depositor relationship runs counter to both pre- and post-*Commercial Cotton* authority . . . we no longer approve the denomination of the ordinary bank-depositor relationship as quasi-fiduciary in character.").

Sensing the new attitude in California, Montana began to rethink the proper role of the bad faith tort. In *Story v. City of Bozeman*,<sup>145</sup> the Supreme Court of Montana reversed a verdict for tortious breach of a construction contract.<sup>146</sup> *Nicholson* had gone too far in extending the bad faith tort to all contracts, the court reasoned; rather, the special relationship defined in *Wallis* must be present before breach of the implied covenant of good faith and fair dealing could sound in tort.<sup>147</sup> Working with this new standard, the Montana Supreme Court later held that a commercial borrower and lender did not enjoy the special relationship necessary to support a bad faith tort claim.<sup>148</sup>

Post-*Foley* decisions in other states hammered more nails into the coffin of the bad faith tort. Idaho, New Jersey, and Utah joined the ranks of states rejecting the tort in the employment context.<sup>149</sup> Other states, including Colorado, Oregon, South Dakota, and Texas, repudiated the tort in several other contexts, such as lending,<sup>150</sup> limited partnership,<sup>151</sup> distributorship,<sup>152</sup> guaranties,<sup>153</sup> and letters of credit.<sup>154</sup> By the 1990s, the only area in which the bad faith tort retained any vitality was insurance.<sup>155</sup>

In sum, it is easy to describe the history of the bad faith tort. The claim was born in the insurance context, experienced a sudden spurt of

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145. 791 P.2d 767 (Mont. 1990).

146. *Id.* at 777.

147. *Id.* at 775-76.

148. *See* First Sec. Bank & Trust v. VZ Ranch, 807 P.2d 1341, 1345 (Mont. 1991).

149. *Metcalf v. Intermountain Gas Co.*, 778 P.2d 744, 748-49 (Idaho 1989); *Noye v. Hoffmann-La Roche, Inc.*, 570 A.2d 12, 15 (N.J. Super. Ct. App. Div.), *cert. denied*, 584 A.2d 218 (N.J. 1990); *Berube v. Fashion Centre, Ltd.*, 771 P.2d 1033, 1046 (Utah 1989).

150. *See* Idaho First Nat'l Bank v. Bliss Valley Foods, Inc., 824 P.2d 841, 864 (Idaho 1991); *Black Canyon Racquetball Club, Inc. v. Idaho First Nat'l Bank*, 804 P.2d 900, 905 (Idaho 1991); *Garrett v. Bankwest, Inc.*, 459 N.W.2d 833, 842 (S.D. 1990).

151. *Friedman v. Colorado Nat'l Bank*, 825 P.2d 1033, 1042-43 (Colo. Ct. App. 1991), *aff'd in part and rev'd in part*, 846 P.2d 159 (Colo. 1993).

152. *See* Adolph Coors Co. v. Rodriguez, 780 S.W.2d 477, 481 (Tex. Ct. App. 1989). Interestingly, Texas law does not impose a common-law duty of good faith and fair dealing in every contract, recognizing the duty only in special relationships marked by shared trust or imbalance in bargaining power. *Federal Deposit Ins. Corp. v. Coleman*, 795 S.W.2d 706, 708-09 (Tex. 1990). Once the duty is imposed, however, its breach sounds in tort, allowing recovery of both actual and punitive damages. *Arnold v. National County Mut. Fire Ins. Co.*, 725 S.W.2d 165, 167-68 (Tex. 1987).

153. *See* *Coleman*, 795 S.W.2d at 709.

154. *See* *Timber Falling Consultants, Inc. v. General Bank*, 751 F. Supp. 179, 184 (D. Or. 1990); *Esso Petroleum Canada v. Security Pac. Bank*, 710 F. Supp. 275, 282 (D. Or. 1989).

155. *See, e.g.*, *Chester v. State Farm Ins. Co.*, 789 P.2d 534, 537 (Idaho Ct. App. 1990); *Norman v. American Nat'l Fire Ins. Co.*, 555 N.E.2d 1087, 1111 (Ill. App. Ct. 1990); *Industrial Indem. Co. v. Kallevig*, 792 P.2d 520, 526 (Wash. 1990); *McCullough v. Golden Rule Ins. Co.*, 789 P.2d 855, 858 (Wyo. 1990).

growth in areas like employment and banking, and then—just as suddenly—died a quiet death in every field but insurance. I now analyze the cases more thoroughly, to identify the policy implications of this history and put Gilmore's theory to the test.

## II. THE QUASI-FIDUCIARY MODEL OF CONTRACT

The history of the bad faith tort raises some difficult questions. Why did contract shade into tort, and then, like a chameleon, change back again? Why did the courts impose remedies that sought to deter and punish breach of contract, only to return to traditional remedies seeking to provide only compensation?

To present definitive answers to the preceding questions is impossible without traveling back in time and entering the minds of the judges who wrote the bad faith tort into existence and then oblivion. This, of course, I cannot do. However, even if I cannot demonstrate with certainty *why* the courts developed and then abandoned the bad faith tort, I can at least study the artifacts of their decision-making process—that is, their written opinions—in an effort to identify the *policy implications* of the birth and death of the bad faith tort. This analysis will enable us to critique Gilmore's theories regarding the social, political, and historical ramifications of the death of contract.

### A. Theories of the Fiduciary Relationship

One of the most striking features of the many decisions involving the bad faith tort is the emphasis on the presence or absence of a special relationship between the contracting parties. By itself the term "special relationship" is not particularly enlightening, since a contractual relationship could be special in a variety of different ways. However, review of insurance cases reveals that some courts have openly characterized the relationship between an insurer and insured as "fiduciary" or "quasi-fiduciary."<sup>156</sup> And, in *Commercial Cotton Co. v. United California*

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156. See, e.g., *Farmers Group, Inc. v. Trimble*, 691 P.2d 1138, 1141-42 (Colo. 1984) (en banc); *Noye v. Hoffmann-La Roche Inc.*, 570 A.2d 12, 15 (N.J. Super. Ct. App. Div.) (dictum), *cert. denied*, 584 A.2d 218 (N.J. 1990); see also William M. Goodman & Thom G. Seaton, *Foreword: Ripe for Decision, Internal Workings and Current Concerns of the California Supreme Court*, 62 CAL. L. REV. 309, 347 (1974) (characterizing insurers as fiduciaries with special responsibilities).

In an interesting recent decision, a California Court of Appeal held that an insurer is not a true fiduciary, but admitted that the relationship between the insurer and insured is *akin* to a fiduciary relationship. See *Love v. Fire Ins. Exch.*, 221 Cal. App. 3d 1136, 1148-49, 271 Cal. Rptr. 246, 252-53 (1990).

*Bank*,<sup>157</sup> the California Court of Appeal affirmed a bad faith tort judgment on the express ground that the relationship between a depositor and its bank was quasi-fiduciary.<sup>158</sup> Therefore, I must investigate the possibility that the special relationship is a kind of fiduciary relationship, or at least similar enough to be described as quasi-fiduciary.

Although the wide variety of fiduciary relationships makes generalization difficult,<sup>159</sup> two commonly asserted theories of the relationship are particularly relevant here.<sup>160</sup> The *reliance theory* holds that a fiduciary relationship exists where one person—the beneficiary—reposes trust, confidence, or reliance in another—the fiduciary.<sup>161</sup> As one scholar has noted, trust, confidence, and reliance are independent ideas; yet, at the same time, each concept carries with it a sense of the beneficiary's vulnerability.<sup>162</sup> Courts often supplement the reliance theory with the requirement that the fiduciary know of the beneficiary's trust, confidence, or reliance.<sup>163</sup>

The *unequal relationship theory*, which tends to follow from the reliance theory, teaches that a fiduciary relationship exists when there is inequality between two persons.<sup>164</sup> Though sometimes narrowly conceived as an imbalance of bargaining power, this inequality is more accurately defined in general terms as a special vulnerability of one person to another.<sup>165</sup> Thus, even though two people have the same bargaining power and enter into the fiduciary relationship as equals, the very nature of the relationship may cause the fiduciary to assume a dominant position with respect to the beneficiary.<sup>166</sup>

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157. 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985).

158. *Id.* at 516, 209 Cal. Rptr. at 554.

159. Three traditional categories of fiduciary relationships have been identified: (1) the fiduciary who holds or manages property on behalf of another, such as a trustee; (2) the fiduciary who acts as a representative for another, such as an agent; and (3) the fiduciary who advises, such as a lawyer, doctor, or minister. J.C. SHEPHERD, *THE LAW OF FIDUCIARIES* 21-32 (1981). Modern times have added other fiduciaries, such as the majority shareholder of a corporation, who fall outside these traditional categories. *Id.* at 32-35.

160. I have chosen to use these commonly asserted theories of the fiduciary relationship as helpful diagnostic tools in interpreting the meaning of certain key phrases in bad faith tort cases. I realize that both theories have been criticized on a variety of descriptive and prescriptive grounds; I do not mean to adopt them as adequate theories of the fiduciary relationship. *See id.* at 56-64.

161. *Id.* at 56; *see also* ERNEST VINTER, *A TREATISE ON THE HISTORY AND LAW OF FIDUCIARY RELATIONSHIP AND RESULTING TRUSTS* 1 (3d ed. 1955) (stating that doctrine of fiduciary relationship embraces all those who are placed in any position of trust).

162. SHEPHERD, *supra* note 159, at 57.

163. *Id.* at 60.

164. *Id.* at 61.

165. *Id.* at 60.

166. *Id.* at 62.

*B. Development of a Quasi-Fiduciary Model of Contract*

## 1. The early cases

The insurance cases provide a good starting point for analysis of the case law in light of these two theories of fiduciary relationships. Although early cases such as *Crisci v. Security Insurance Co.*<sup>167</sup> and *Gruenberg v. Aetna Insurance Co.*<sup>168</sup> often did not explain why breach of the implied covenant of good faith and fair dealing should sound in tort, recent decisions have identified several factors justifying recognition of the bad faith tort within the insurance context.

The first relevant factor is the motivation of the insured in purchasing the insurance.<sup>169</sup> As the insurer is well aware, the insured does not seek commercial advantage, but rather the peace of mind and financial security that insurance provides in case of accidental loss.<sup>170</sup> Translating this reasoning into the language of fiduciary theory, the insured reposes trust, confidence, and reliance in the insurer to protect against accidental loss; and the insurer is aware of this reliance. Thus, the first factor evokes the reliance theory of the fiduciary relationship.

The second relevant factor is the vulnerability of the insured should accidental loss occur.<sup>171</sup> Since an insured can no longer purchase substitute insurance after an accident occurs, insureds must depend upon the good faith performance of their insurers.<sup>172</sup> Interpreting this reasoning in light of fiduciary theory, the fact that the insured must rely upon the insurer to perform recalls the reliance theory of the fiduciary relationship. At the same time the utter dependence of the insured upon the insurer reflects a power imbalance inherent in the nature of the insurance contract, evoking the unequal relationship theory of the fiduciary relationship.

The third and final relevant factor is the great disparity in economic strength and bargaining ability between the insurer and insured.<sup>173</sup> This imbalance in bargaining power at the outset of the relationship reflects another aspect of the unequal relationship theory of the fiduciary relationship.

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167. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

168. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

169. See *Wallis v. Superior Court*, 160 Cal. App. 3d 1109, 1117, 207 Cal. Rptr. 123, 128 (1984).

170. See *Foley v. Interactive Data Corp.*, 47 Cal. 3d 654, 690, 765 P.2d 373, 396, 254 Cal. Rptr. 211, 234 (1988); *Wallis*, 160 Cal. App. 3d at 1117, 207 Cal. Rptr. at 128.

171. See *Wallis*, 160 Cal. App. 3d at 1118, 207 Cal. Rptr. at 128-29.

172. See *Foley*, 47 Cal. 3d at 692, 765 P.2d at 396, 254 Cal. Rptr. at 234; *Wallis*, 160 Cal. App. 3d at 1118, 207 Cal. Rptr. at 128.

173. See *Wallis*, 160 Cal. App. 3d at 1117, 207 Cal. Rptr. at 128.

Reviewing those cases that extended the bad faith tort beyond the insurance context, I find more reasoning consistent with the reliance and unequal relationship theories of the fiduciary relationship. Consider, for example, *K Mart Corp. v. Ponsock*.<sup>174</sup> There, in an attempt to evade its obligation to pay retirement benefits, an employer fired a tenured employee six months before his retirement benefits would have vested.<sup>175</sup> The employee responded by alleging breach of contract and tortious breach of the covenant of good faith and fair dealing.<sup>176</sup> A jury awarded the employee a generous measure of both compensatory and punitive damages, and the employer appealed.<sup>177</sup>

The Nevada Supreme Court reasoned that tort remedies were appropriate only when there was a special relationship between the parties marked by certain characteristics, including a "superior-inferior power differential" creating a "special element of reliance."<sup>178</sup> The court found this power differential and special reliance woven into the very fabric of the modern employment relationship:

"We have become a nation of employees. We are dependent upon others for our means of livelihood, and most of our people have become completely dependent upon wages. If they lose their jobs they lose every resource except for the relief supplied by the various forms of social security. Such dependence of the mass of the people upon others for *all* of their income is something new in the world. *For our generation, the substance of life is in another man's hands.*"<sup>179</sup>

The employee had relied upon the employer's promise to retain him, the court reasoned, just as an insured relies upon the insurer's promise of indemnity.<sup>180</sup> Given the special relationship of trust between the parties, the employer's abusive and arbitrary dismissal of the employee demanded a remedy that went beyond traditional contract damages.<sup>181</sup> Accordingly, the award of bad faith tort damages was proper, and must be affirmed.<sup>182</sup>

Reading the above case through the prism of fiduciary theory, the emphasis upon the economic dependency of the modern employee re-

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174. 732 P.2d 1364 (Nev. 1987).

175. *Id.* at 1365.

176. *Id.*

177. *Id.* at 1368-73.

178. *Id.* at 1370-71.

179. *Id.* at 1372 (quoting F. TANNENBAUM, A PHILOSOPHY OF LABOR 9 (1951)).

180. *Id.*

181. *Id.*

182. *Id.* at 1373.

flects concern about a power imbalance inherent in the nature of the employment relationship. Given this imbalance, the employment relationship is somewhat similar—if not identical—to a fiduciary relationship as conceived under the unequal relationship theory. At the same time the emphasis upon the special relationship of trust between the employee and employer calls to mind the reliance theory of the fiduciary relationship.

Similarly, in the *Wallis v. Superior Court* case, the California Court of Appeal employed reasoning consistent with the reliance and unequal relationship theories of the fiduciary relationship. There, an employer had contracted to provide a former employee with monthly support stipends, but later reneged on its promise.<sup>183</sup> Applying its five-part special relationship test, the court concluded that the former employee could assert a bad faith tort claim.<sup>184</sup>

Working with the first prong of the test, the court reasoned that the parties were in inherently unequal bargaining positions when the contract was made, since the former employee needed the stipend and had few marketable skills.<sup>185</sup> By stressing this imbalance in bargaining power, the court unconsciously evoked the unequal relationship theory of the fiduciary relationship. Continuing, the court found that the second prong of the special relationship test was also satisfied; the former employee had entered into the contract for the payment of a monthly stipend to obtain financial security and peace of mind.<sup>186</sup> This reasoning, which stressed the employee's reliance upon his former employer to safeguard him from harm, brings to mind the reliance theory of the fiduciary relationship.

The third prong of the special relationship test is not relevant here,<sup>187</sup> but the fourth and fifth prongs are. The court emphasized that the former employee was extremely vulnerable to harm upon breach due to his advanced age, lack of other work skills, and financial responsibilities.<sup>188</sup> Moreover, the employer was well aware of this vulnerability.<sup>189</sup> Again, the emphasis upon the extent to which the former employee relied upon the employer to perform, and the employer's knowledge of this reliance, is consistent with the reliance theory of the fiduciary relationship. At the same time the employee's vulnerability to his former employer

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183. See *Wallis*, 160 Cal. App. 3d at 1113, 207 Cal. Rptr. at 125.

184. See *id.* at 1118-19, 207 Cal. Rptr. at 129.

185. *Id.* at 1119, 207 Cal. Rptr. at 129.

186. *Id.*

187. Consideration of the third prong is deferred to *infra* part III.

188. *Wallis*, 160 Cal. App. 3d at 1119, 207 Cal. Rptr. at 129.

189. *Id.*



reflects a power imbalance inherent in their contractual relationship. Thus, the court's analysis of the fourth and fifth prongs also evokes the unequal relationship theory of the fiduciary relationship.

The logic of the controversial decision in *Commercial Cotton Co. v. United California Bank* also resonates with fiduciary theory. There, the California Court of Appeal affirmed a bad faith tort judgment on the basis that the relationship between a commercial depositor and its bank was "quasi-fiduciary."<sup>190</sup> Banking and insurance have much in common, the court noted, since both are highly regulated industries performing vital public services affecting the public welfare.<sup>191</sup> Moreover, the depositor was completely dependent on the bank, relying on its honesty and expertise to protect deposited funds.<sup>192</sup> He maintained the account for two reasons: the convenience of transacting business without cash and the security of having the bank safeguard deposited funds.<sup>193</sup> This language, identifying security as the motivation for entering the deposit contract, is consistent with the reliance theory of the fiduciary relationship.

Just as California and Nevada used the quasi-fiduciary model of contract as a basis for extending the bad faith tort beyond the insurance field, other states declined to extend the bad faith tort to situations where the quasi-fiduciary model did not seem to fit. Some decisions emphasized the absence of the trust, confidence, or reliance so characteristic of the fiduciary relationship. For example, the Oklahoma Supreme Court noted that the purpose of a commercial loan was not to provide security, but rather to facilitate risk taking in business.<sup>194</sup> Similarly, the Arizona Court of Appeals opined that the purpose behind a home purchase was not security, but rather the acquisition of a tangible asset.<sup>195</sup> Other decisions stressed the lack of any inequality of position between the parties. Thus, the Nevada Supreme Court declined to extend tort remedies to a commercial lessor who was "an experienced business person and an attorney."<sup>196</sup>

To summarize the analysis so far, the cases that developed and extended the bad faith tort demonstrated a strong tendency to emphasize attributes of the contractual relationships before them that were consis-

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190. *Commercial Cotton Co. v. United Cal. Bank*, 163 Cal. App. 3d 511, 516, 209 Cal. Rptr. 551, 554 (1985).

191. *Id.*

192. *Id.*

193. *Id.*

194. *See* *Rodgers v. Tecumseh Bank*, 756 P.2d 1223, 1226 (Okla. 1988).

195. *See* *Oldenburger v. Del E. Webb Dev. Co.*, 765 P.2d 531, 535 (Ariz. Ct. App. 1988).

196. *See* *Aluevich v. Harrah's*, 660 P.2d 986, 987 (Nev. 1983), *cert. denied*, 465 U.S. 1006 (1984).

tent with the salient characteristics of a fiduciary relationship, such as (1) the trust, confidence, and reliance that one party placed in the other, and (2) inequality between the parties, whether existing at the time the contract was made or arising later as an incident of the contractual relationship.

Furthermore, once the presence of a special relationship was established, the courts defined the good faith obligation so that it began to approach a fiduciary obligation. Under classical fiduciary doctrine, fiduciaries owe a duty of loyalty; they must act *solely* in the best interests of their charges, without regard to their own interests.<sup>197</sup> In cases recognizing the bad faith tort, the courts held the stronger contracting party to a similar, though not identical, standard: The stronger party was required to give the best interests of the weaker party at least as much consideration as its own.<sup>198</sup> As the *Wallis* court put it, the stronger contracting party has "a heightened duty not to act unreasonably in breaching the contract, and to consider the interest of the other party as tantamount to its own."<sup>199</sup>

In theory, the stronger contracting party had less obligation than the fiduciary, since it was not required to abandon its own interests altogether. In practice, however, the good faith obligation came closer to the fiduciary duty of loyalty. For example, the financial interests of an insurer and its insured are always at odds, since payment of a claim simply shifts money from insurer to the insured or a third-party claimant.<sup>200</sup> Due to this inherent conflict, the insurer *cannot* give the financial interests of the insured the *same* consideration as its own. Rather, it must either put its own financial interests first—thereby violating the good faith obligation—or place the insured's financial interests *ahead* of its own, as a fiduciary would be required to do.

The foregoing analysis shows that the rise of the bad faith tort was founded in part upon the judicial invention of a new model of contract. This model stressed attributes of the contractual relationship that were comparable to characteristics of the fiduciary relationship, and imposed a

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197. See, e.g., GEORGE T. BOGERT, TRUSTS § 95 (6th ed. 1987) (trustee must administer trust solely in interest of beneficiaries); 2A SCOTT & FRATCHER, *supra* note 110, § 170 (same); see also RESTATEMENT (SECOND) OF AGENCY § 387 (1957) (noting agent has duty to act solely for benefit of principal); HAROLD G. REUSCHLEIN & WILLIAM A. GREGORY, HANDBOOK ON THE LAW OF AGENCY AND PARTNERSHIP § 4 (1979) (same).

198. See, e.g., *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 818-19, 620 P.2d 141, 145, 169 Cal. Rptr. Supp. 691, 695 (1979), *cert. denied and appeal dismissed*, 445 U.S. 912 (1980); *Silberg v. California Life Ins. Co.*, 11 Cal. 3d 452, 460, 521 P.2d 1103, 1109, 113 Cal. Rptr. 711, 716-17 (1974).

199. *Wallis*, 160 Cal. 3d at 1118, 207 Cal. Rptr. at 129.

200. *Foley*, 47 Cal. 3d at 693, 765 P.2d at 396, 254 Cal. Rptr. at 234.

good faith obligation upon the stronger contracting party that was similar to the duty of loyalty imposed upon the fiduciary. Although the new model could not be classified as a true fiduciary relationship, the courts' frequent—though sometimes unconscious—analogies to fiduciary theory suggest that the model is best described as *quasi-fiduciary*; that is, similar or akin to a fiduciary relationship.<sup>201</sup>

## 2. Implications of the early cases

Concluding that the early bad faith tort decisions were based upon a quasi-fiduciary model of contract does not end my inquiry. Fiduciary law must be analyzed in greater depth to ascertain the policy foundation of the quasi-fiduciary model.

Professor Tamar Frankel has described the moral foundation of fiduciary law as "altruism": "The moral person serves other members of the society and contributes to society generally."<sup>202</sup> Frankel speculates that a possible reason for the judicial incorporation of altruism into fiduciary law is vulnerability.

[T]he moral posture of fiduciaries is related to the vulnerability of the entrustor. It is wrong to injure anyone. But it is more reprehensible to injure someone who cannot protect himself, as an entrustor in a fiduciary relation is. Thus, the degree of moral culpability of the fiduciary is positively related to the extent of the entrustor's helplessness.<sup>203</sup>

Frankel's theory of the moral foundation of fiduciary law is relevant to my analysis because it is consistent with the reasoning employed in the early bad faith tort cases. As I have shown, the quasi-fiduciary model of contract emphasized the reliance of the weaker contracting party upon the stronger, or the imbalance of power between the parties—that is, factors revealing the *vulnerability* of the weaker party. Reasoning by analogy to Frankel, such vulnerability would provide the necessary foundation for the incorporation of altruism into contract law via the quasi-fiduciary model. Moreover, the quasi-fiduciary model required the stronger contracting party to give the interests of the weaker party at least as much consideration as its own. Thus, the stronger contracting party had a special responsibility for the welfare of the weaker party—it was required to act as its brother's keeper. Reasoning by analogy to

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201. See, e.g., *Love v. Fire Ins. Exch.*, 221 Cal. App. 3d 1136, 1147-49, 271 Cal. Rptr. 246, 251-53 (1990) (noting that insurer is not true fiduciary, but relationship between insurer and insured is *akin* to fiduciary relationship).

202. Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 830 (1983).

203. *Id.* at 832.

Frankel, the quasi-fiduciary model demanded that the stronger contracting party act altruistically, serving the weaker party, perhaps even at its own expense.

Accepting altruism as the foundation of the quasi-fiduciary model of contract, it is clear why courts imposed tort remedies for bad faith breach of contract. If the stronger contracting party had an altruistic obligation to perform for the benefit of the weaker party, then bad faith breach must have appeared as an unacceptably selfish and, therefore, immoral act. Tort remedies served to deter and punish this immoral conduct.

Having completed analysis of the quasi-fiduciary model, I am ready to comment on Gilmore's theory of the death of contract. Recall that Gilmore had characterized classical contract theory as "dedicated to the proposition that, ideally, no one should be liable to anyone for anything."<sup>204</sup> Toward this end, contract damages had been kept low, and sharply differentiated from tort damages.<sup>205</sup> Thus, he reasoned, the broadening of remedies for breach of contract during the twentieth century signalled the demise of classical theory.<sup>206</sup>

If the premise that limited contract remedies are a key element of classical contract theory is accepted, then the rise of the bad faith tort, which substituted tort for contract remedies, seemed to validate Gilmore's theory that contract was dead—or at the very least, gravely wounded. What could provide greater evidence that contract was being reabsorbed into the mainstream of tort<sup>207</sup> than the imposition of tort remedies for breach of contract?

Furthermore, the rise of the quasi-fiduciary model of contract provided temporary support for Gilmore's speculation that contract was the victim of a cultural trend towards greater social responsibility. Quoting at length from the legal historical work of Professor Lawrence Friedman, Gilmore argued that classical contract theory was founded upon individual autonomy.

"Basically, then, the 'pure' law of contract is an area of what we can call abstract relationships. 'Pure' contract doctrine is blind to details of subject matter and person. It does not ask who buys and who sells, and what is bought and sold . . . . Contract law is abstraction—what is left in the law relat-

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204. GILMORE, *supra* note 1, at 14.

205. *Id.* at 48.

206. *Id.* at 83-84.

207. *Id.* at 87.

ing to agreements when all particularities of person and subject-matter are removed.

. . . The abstraction of classical contract law is not unrealistic; it is a deliberate renunciation of the particular, a deliberate relinquishment of the temptation to restrict untrammelled individual autonomy or the completely free market in the name of social policy. The law of contract is, therefore, roughly coextensive with the free market. Liberal nineteenth-century economics fits in neatly with the law of contracts so viewed. It, too, had the abstracting habit. In both theoretical models—that of the law of contracts and that of liberal economics—parties could be treated as individual economic units which, in theory, enjoyed complete mobility and freedom of decision.”<sup>208</sup>

Thus, Gilmore reasoned, during the nineteenth century the law assumed a narrow scope of social duty, reflected in slogans like: “No man is his brother’s keeper; the race is to the swift; let the devil take the hindmost.”<sup>209</sup> But, during the twentieth century, he asserted, the cultural landscape had undergone a drastic change, as indicated by the death of contract.

For good or ill, we have changed all that. We are now all cogs in a machine, each dependent on the other. The decline and fall of the general theory of contract and, in most quarters, of laissez-faire economics, may be taken as remote reflections of the transition from nineteenth century individualism to the welfare state and beyond.<sup>210</sup>

Similarly, the early bad faith tort decisions were founded upon the quasi-fiduciary model of contract. Under the quasi-fiduciary model, a stronger contracting party could not disclaim responsibility for the

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208. *Id.* at 6-7 (quoting LAWRENCE M. FRIEDMAN, *CONTRACT LAW IN AMERICA* 20-21 (1965)).

209. *Id.* at 95.

210. *Id.* at 95-96. Frankel has diagnosed a similar cultural trend, from individual freedom towards *fiduciary* responsibility:

A contract society values freedom and independence highly, but it provides little security for its members. An example of a society based primarily on contract is the market society of the United States during the Industrial Revolution.

I submit that we are witnessing the emergence of a society predominantly based on fiduciary relations. This type of society best reflects our contemporary social values. In our society, affluence is largely produced by interdependence, but personal freedom is cherished. Society’s members turn to an arbitrator, the government, to obtain protection from personal coercion by those on whom they depend for specialized services. A fiduciary society attempts to maximize both the satisfaction of needs and the protection of freedom.

Frankel, *supra* note 202, at 802.

welfare of the weaker party; rather, it was required to act as its brother's keeper. Therefore, the rise of the bad faith tort, and apparent decline in the vitality of contract, reflected an emphasis upon social responsibility.<sup>211</sup>

### C. *Abandonment of the Quasi-Fiduciary Model of Contract*

But, the impression that contract was suffering a decline was only a temporary illusion. The bad faith tort was about to take a tumble, and a key factor in its fall from grace would be the growing reluctance of the courts to accept the quasi-fiduciary model of contract outside the insurance context.

#### 1. The later cases

Consider, for example, *Foley v. Interactive Data Corp.*<sup>212</sup> and its progeny. In *Foley* the California Supreme Court carefully distinguished the employment relationship from the insurance relationship. The court reasoned that, unlike an insured seeking to purchase security against potential economic loss, an employee does not seek any security other than the profit to be gained from a commercial contract.<sup>213</sup> In other words, the employee does not place special trust or confidence in an employer to shelter him or her from harm. Moreover, unlike an insured, an employee has an important option, even in the face of bad faith discharge: The employee can always seek alternative employment.<sup>214</sup> In other words, the nature of the employment contract does not require the employee to rely upon the good faith performance of the employer. Thus, as described in *Foley*, the employment relationship is *inconsistent* with the reliance theory of the fiduciary relationship.

This emphasis upon the alternatives available to the employee can be read in another light. Given that an employee can seek alternative employment, and is not utterly dependent upon the employer, the employment contract contains no inherent power imbalance. Thus, as conceived by the *Foley* court, the employment relationship is also inconsistent with the unequal relationship theory of the fiduciary relationship.

After *Foley*, the California Court of Appeal quickly moved to reject bad faith tort claims in a variety of commercial contexts, often on the

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211. However, as I demonstrate, the rise of the tort did *not* reflect a corresponding move away from respect for individual freedom. See *infra* part III.

212. 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211 (1988).

213. *Id.* at 692, 765 P.2d at 396, 254 Cal. Rptr. at 234.

214. *Id.*

grounds that no reliance or inequality existed. For example, in *Martin v. U-Haul Co.*,<sup>215</sup> the court held that a gas station owner who dealt in rental equipment as a side business could not assert the bad faith tort against his supplier when it terminated his equipment dealership contract since the parties did not have a special relationship.<sup>216</sup> In so holding the court emphasized that the dealer had bargained with the supplier at arm's length, and had the option of doing business with many other equipment rental firms;<sup>217</sup> in other words, there was no inequality of position between the parties at the time the relationship was formed. Furthermore, the court continued, profit, not security, was the basis of the relationship between the parties.<sup>218</sup> The dealer was not especially vulnerable to a termination of his dealership contract because he could deal with other rental equipment suppliers.<sup>219</sup> In addition, renting equipment was not the dealer's primary source of income.<sup>220</sup> Thus, there was no power imbalance inherent in the contractual relationship, nor did any evidence exist that the dealer had relied upon the supplier for protection or support.

Another recent decision displaying reluctance to invoke the quasi-fiduciary model of contract was *Careau & Co. v. Security Pacific Business Credit*.<sup>221</sup> There, the California Court of Appeal held that breach of a commercial loan contract did not sound in tort.<sup>222</sup> The court curtly rejected the possibility that the lender and borrower occupied unequal positions from the outset of the relationship: "There were no indicia of unequal bargaining here, no adhesive agreements, no indication that one party had any particular advantage over the other."<sup>223</sup> Nor did the court discern any inherent power imbalance or special reliance upon the

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215. 204 Cal. App. 3d 396, 251 Cal. Rptr. 17 (1988).

216. *Id.* at 415, 251 Cal. Rptr. at 28; *see also* Premier Wine & Spirits v. E. & J. Gallo Winery, 644 F. Supp. 1431, 1436-37 (E.D. Cal. 1986), *aff'd*, 846 F.2d 537 (9th Cir. 1988) (finding no special relationship between wine distributor and supplier that would support bad faith tort claim for termination of distributorship).

217. *Martin*, 204 Cal. App. 3d at 414, 251 Cal. Rptr. at 27.

218. *Id.* at 413-14, 251 Cal. Rptr. at 26-27.

219. *Id.*

220. *Id.*, 251 Cal. Rptr. at 27.

221. 222 Cal. App. 3d 1371, 272 Cal. Rptr. 387 (1990).

222. *Id.* at 1400-01, 272 Cal. Rptr. at 404; *accord* Price v. Wells Fargo Bank, 213 Cal. App. 3d 465, 475, 261 Cal. Rptr. 735, 739 (1989); Mitsui Mfrs. Bank v. Superior Court, 212 Cal. App. 3d 726, 731-33, 260 Cal. Rptr. 793, 796-97 (1989).

223. *Careau & Co.*, 222 Cal. App. 3d at 1400, 272 Cal. Rptr. at 403; *accord* Mitsui Mfrs. Bank, 212 Cal. App. 3d at 732, 260 Cal. Rptr. at 796 (holding no unfairness or inequality in negotiations resulting in commercial loan contract).

lender; the borrowers "were [neither] in a particularly vulnerable position nor in need of any special protection."<sup>224</sup>

Perhaps the most compelling evidence of the decline of the quasi-fiduciary model of contract came with the decision in *Copesky v. Superior Court*.<sup>225</sup> The California Court of Appeal expressly repudiated its earlier decision in *Commercial Cotton Co. v. United California Bank*,<sup>226</sup> holding that breach of a contract regarding a commercial checking account did not sound in tort.<sup>227</sup> Once again, the court found no inequality of position between the parties, reasoning that a commercial depositor and its bank were not ordinarily in inherently unequal bargaining positions.<sup>228</sup> The court also argued that the primary purpose of the account was profit, rather than security,<sup>229</sup> and that the depositor faced no special vulnerability in the event of breach.<sup>230</sup> By making this argument the court rejected any notion that there was a power imbalance inherent in the contract, or that the depositor had reposed special trust, confidence, or reliance in the bank.<sup>231</sup> Finally, and perhaps most significantly, the *Copesky* court took special pains to renounce its earlier characterization in *Commercial Cotton* of the bank-depositor relationship as quasi-fiduciary.<sup>232</sup> The bank, it reasoned, dealt at arm's length and in commercial independence with its depositor.<sup>233</sup> It was not obliged to put the interests of the depositor ahead of its own.<sup>234</sup>

Post-*Foley* decisions in other states have been singing the same tune. Stressing the lack of any inequality between the parties, the Texas Court of Appeals declined to extend tort remedies to a distributor that did not "require special protection" against its supplier.<sup>235</sup> Similarly, the Idaho Supreme Court declined to grant tort remedies to experienced commercial borrowers who bargained on equal terms with their lenders.<sup>236</sup> And, going right to the heart of the matter, the Colorado Court of Appeals and the New Jersey Superior Court flatly refused to apply the fiduciary label

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224. *Careau & Co.*, 222 Cal. App. 3d at 1400, 272 Cal. Rptr. at 403.

225. 229 Cal. App. 3d 678, 280 Cal. Rptr. 338 (1991).

226. 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985).

227. *Copesky*, 229 Cal. App. 3d at 694, 280 Cal. Rptr. at 348.

228. *Id.* at 691, 280 Cal. Rptr. at 346.

229. *Id.*

230. *Id.* at 692, 280 Cal. Rptr. at 347.

231. *Id.*

232. *Id.* at 692-93, 280 Cal. Rptr. at 347-48.

233. *Id.* at 693 n.4, 280 Cal. Rptr. at 348 n.4.

234. *Id.*

235. See *Adolph Coors Co. v. Rodriguez*, 780 S.W.2d 477, 481 (Tex. Ct. App. 1989).

236. See *Black Canyon Racquetball Club, Inc. v. Idaho First Nat'l Bank*, 804 P.2d 900, 905 (Idaho 1991).



to relationships between general and limited partners<sup>237</sup> and employees and employers,<sup>238</sup> respectively.

## 2. Implications of the later cases

How can we explain this decline in the quasi-fiduciary model of contract? What implications do the later bad faith decisions hold for the future of contract?

To some extent, the decline of the quasi-fiduciary model of contract may simply reflect the fact that few contracts fit the model. Under this view early cases addressed relationships where reliance or inequality made one party unusually vulnerable to the other. For example, insureds are in a particularly vulnerable position; they cannot purchase substitute insurance once loss occurs, and they are entirely dependent upon the good faith performance of their insurers. Similarly, the fifty-five-year-old former employee in *Wallis v. Superior Court*<sup>239</sup> was particularly vulnerable; he had few options in the employment market and depended on his former employer to pay his monthly support stipend.<sup>240</sup> By contrast, many of the later cases that rejected the quasi-fiduciary model involved ordinary commercial relationships—such as equipment dealerships or commercial loans—in which neither party was particularly vulnerable to the other. Absent any such vulnerability, the later cases would have had no reason to adopt tort remedies as a means of vindicating a moral obligation of the stronger party to look after the weaker party.

The foregoing argument has some force; undoubtedly, the range of the quasi-fiduciary model of contract has natural limits. Nevertheless, the argument does not explain why the courts placed some relationships, such as employment and banking, first within, and then outside those limits. The answer cannot lie solely in the nature of those relationships for, with some justification, the early cases had identified indicia of reliance and inequality that placed employment and deposit contracts squarely within the quasi-fiduciary model. For example, the *K Mart Corp. v. Ponsock*<sup>241</sup> court found reliance and inequality woven into the employment contract at issue.<sup>242</sup> Similarly, in *Commercial Cotton Co. v.*

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237. See *Friedman v. Colorado Nat'l Bank*, 825 P.2d 1033, 1042-43 (Colo. Ct. App. 1991), *aff'd in part and rev'd in part*, 846 P.2d 169 (Colo. 1993).

238. See *Noye v. Hoffmann-La Roche, Inc.*, 570 A.2d 12, 15 (N.J. Super. Ct. App. Div.), *cert. denied*, 584 A.2d 218 (N.J. 1990).

239. 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984).

240. *Id.* at 1113, 207 Cal. Rptr. at 125.

241. 732 P.2d 1364 (Nev. 1987).

242. *Id.* at 1371-72.

*United California Bank*,<sup>243</sup> the court argued that a commercial depositor was completely dependent on the bank, relying on its honesty and expertise to protect deposited funds.<sup>244</sup> Yet, only a few years later, the *Foley v. Interactive Data Corp.*<sup>245</sup> court flatly denied that the employment relationship was "special," reasoning that employees do not seek security from their employers, and can always seek alternative employment in case of discharge.<sup>246</sup> And the court in *Copesky v. Superior Court*<sup>247</sup> expressly repudiated *Commercial Cotton Co.*, arguing that a commercial depositor sought profit rather than security and faced no special vulnerability in event of breach.<sup>248</sup>

In light of these contradictions, it is reasonable to conclude that the courts moved from a generous, expansive interpretation of the quasi-fiduciary model to a narrow, more limited interpretation. Consequently, tort remedies were rejected in favor of traditional, limited contract remedies. Accepting Gilmore's own premise that limited contract remedies are a key element of classical contract theory, the recent cases represent a reaffirmation of that theory. Thus, contract is *not* dead, but rather very much alive.

Furthermore, by developing the quasi-fiduciary model and awarding tort remedies for bad faith breach of contract, the early decisions imposed a moral obligation upon the stronger contracting party to behave altruistically, serving the weaker party through contract performance. But recent decisions have limited the quasi-fiduciary model and rejected tort remedies, suggesting that altruism has been outweighed by other policy considerations that support traditional, limited contract remedies.<sup>249</sup>

### III. INDIVIDUAL AUTONOMY

Thus far, I have identified one policy implication of the early bad faith tort decisions: an emphasis upon altruism, defined as the moral obligation of the stronger contracting party to act as the weaker party's keeper through contract performance. I analyzed altruism first because it was most clearly expressed in the language and reasoning of the relevant cases. Like a blazing torch in the night, this policy implication was relatively simple to detect and describe. Now, it is time to turn to an-

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243. 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985).

244. See *id.* at 516, 209 Cal. Rptr. at 554.

245. 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211 (1988).

246. *Id.* at 692, 765 P.2d at 396, 254 Cal. Rptr. at 234.

247. 229 Cal. App. 3d 678, 280 Cal. Rptr. 338 (1991).

248. *Id.* at 693-94, 280 Cal. Rptr. at 348.

249. See *infra* part IV.

other policy implication of the early cases. Like a smoke signal scattered across a darkening sky, this implication is more difficult to see, but it carries an important message that must not be overlooked.

*A. Individual Autonomy as the Moral Basis of Promise*

The idea that there is a moral obligation to keep promises is not new. As Dean Roscoe Pound wrote:

From antiquity the moral obligation to keep a promise had been a cardinal tenet of ethical philosophers, publicists, and philosophical jurists. Thus, Plato quotes a saying of Simonides that justice is speaking the truth and the Platonists later spoke of justice as truthfulness. Demosthenes argued that the laws should be obeyed because men, as citizens, had agreed to do so. Cicero, in a treatise on duties had put stress on the *prisca fides*, good faith keeping of promises, by the old Romans. Faithful keeping of a promise was a tenet of Christian morals pronounced by a council of the early church incorporated in the corpus of the canon law. The seventeenth-century jurists of the law-of-nature school repeated it as a proposition of natural law. . . . The Declaration of Independence laid down that government derived its just powers from the consent of the governed who contracted to be bound.<sup>250</sup>

Throughout the centuries scholars and philosophers have propounded a wide range of theories describing the origin of the moral obligation to keep promises.<sup>251</sup> Such hypotheses range from the reliance theory, which urges that promises must be kept because promisees rely upon them,<sup>252</sup> to the layperson's intuition that promises are sacred per se, making the breaking of promises inherently despicable and intolerable in a properly organized society.<sup>253</sup> Any attempt to list and categorize all these theories would be well beyond the scope of this Article. Nevertheless, in order to continue my analysis, I will choose and work with one theory of the moral obligation to keep promises.

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250. Roscoe Pound, *Promise or Bargain?*, 33 TUL. L. REV. 455 (1959).

251. See generally *id.* at 458-63 (describing several theories of moral obligation to keep promises).

252. See P.S. ATIYAH, *THE RISE AND FALL OF FREEDOM OF CONTRACT* 184-89 (1979).

253. See Pound, *supra* note 250, at 459; see also Mark Pennington, *Punitive Damages for Breach of Contract: A Core Sample from the Decisions of the Last Ten Years*, 42 ARK. L. REV. 31, 45 (1989) (explaining recent tendency to award punitive damages for breach of contract as "reflecting a belief of the general public[ ] that breaking a promise is a serious wrong which ought to be punished").

In his book *Contract as Promise*, Professor Charles Fried argues that the purpose of promise is the maximization of individual autonomy.<sup>254</sup> The convention of promising allows individuals to give their free will the greatest possible range.<sup>255</sup> By committing themselves to particular courses of action, individuals can participate in the projects of others who must count on their future conduct.<sup>256</sup> Thus, although promising may seem to restrict autonomy, in fact the restrictions involved in promising are undertaken in order to increase future options, and are consistent with the principle of autonomy.<sup>257</sup>

Once the convention of promising has been invoked, Fried reasons, it is wrong to break the promise. Fried states:

[T]he obligation to keep a promise is grounded not in arguments of utility but in respect for individual autonomy and in trust. . . . An individual is morally bound to keep his promises because he has intentionally invoked a convention whose function it is to give grounds—moral grounds—for another to expect the promised performance. To renege is to abuse a confidence he was free to invite or not, and which he intentionally did invite. To abuse that confidence now is like (but only *like*) lying: the abuse of a shared social institution that is intended to invoke the bonds of trust.<sup>258</sup>

Fried's theory as to why promises must be kept is squarely based on the individual and his or her right to freedom. The purpose of promise is to maximize freedom, and the moral obligation to keep promises is founded upon respect for the exercise of individual freedom. "[R]espect for others as free and rational requires taking seriously their capacity to determine their own values."<sup>259</sup> Therefore, while Fried characterizes the promise breaker as someone who abuses trust, he perceives the obligation to keep promises as essentially based on the *conduct* of the promisor, rather than on the expectations or needs of the promisee.<sup>260</sup>

There are two reasons why Fried's theory of promise recommends itself as a promising vehicle for my analysis. First, based upon notions of individual freedom and responsibility, the theory is consistent with a persistent *leitmotif* in American society. Individual freedom remains a pri-

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254. CHARLES FRIED, *CONTRACT AS PROMISE* 16 (1981).

255. *See id.* at 13.

256. *Id.*

257. *Id.* at 14.

258. *Id.* at 16 (endnotes omitted).

259. *Id.* at 20.

260. *See id.* at 10-11.

mary value within our culture. Witness the continued vitality of the "bad samaritan" rule. In the name of individual liberty,<sup>261</sup> it states that a person has no duty to offer assistance to another in dire need.<sup>262</sup> Additionally, consider the undiminished vigor of the First Amendment, which continues to guarantee the right to say what one wants free of governmental restriction, despite attempts to ban flag burning<sup>263</sup> or to restrict certain types of speech on college campuses.<sup>264</sup>

Second, Fried's theory, which emphasizes individual autonomy, contrasts sharply with the quasi-fiduciary model of contract, which emphasizes the moral obligation of the strong to look after the weak. Thus, Fried's theory permits us to critique Gilmore's theory from a fresh, new perspective.

### *B. Relationships Involving Incentive to Breach*

#### 1. The early cases

Armed with Fried's theory of promise, I am prepared to analyze and explain the early success of the bad faith tort, beginning with the insurance context.

Consider the nature of the insurance relationship. The insured performs its promise by first paying the premium to the insurer. Should a specified illness, catastrophe, or other loss occur, the insurer pays the amount of the policy to the insured. The problem is that the insurer has little incentive to perform once the loss has occurred. On the one hand, performance would help to keep the insured satisfied; but, the insured's satisfaction is not particularly important. The premium has already been paid and the goodwill of one customer has little value to a large insurance company. On the other hand, performance would hurt the insurer financially: Payment under the policy would shift funds from the insurer to the insured or to a third-party claimant. Thus, the very nature of the insurance relationship creates a strong economic incentive for the insurer to break its promise to the insured. Such incentive could induce widespread promise breaking within the insurance context.

Significantly, the courts have identified the insurer's overwhelming incentive to breach as a reason to adopt tort remedies within the insur-

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261. See, e.g., Marc A. Franklin, *Vermont Requires Rescue: A Comment*, 25 STAN. L. REV. 51, 51 (1972); Robert L. Hale, *Prima Facie Torts, Combination, and Non-Feasance*, 46 COLUM. L. REV. 196, 214 (1946).

262. See KEETON ET AL., *supra* note 43, § 56, at 375.

263. See *United States v. Eichman*, 496 U.S. 310 (1990); *Texas v. Johnson*, 491 U.S. 397 (1989).

264. See *Doe v. University of Mich.*, 721 F. Supp. 852 (E.D. Mich. 1989).

ance context. As one court has noted, performance of the contract involves a wealth transfer from insurer to insured or to a third-party claimant;<sup>265</sup> thus, the insurer has a strong incentive to break its promise and reject the insured's claim. In the face of this incentive, contract remedies offer "no motivation whatsoever for the insurer *not* to breach."<sup>266</sup> The classic remedy for breach of contract is expectation damages—that is, an award of money that places the promisee in the same position it would have enjoyed if the promisor had performed its promise.<sup>267</sup> At worst an award of expectation damages would require the insurer to pay the amount owed under the policy. At best the insurer might force the insured into a pretrial settlement for less than the policy amount.<sup>268</sup> Thus, the courts have concluded that tort remedies must be adopted in order to provide a meaningful deterrent against bad faith breach.

Examining the early success of the bad faith tort in other contexts, I note cases involving the same problem: a contractual relationship giving one party a strong economic incentive to breach. For example, the employer in *K Mart Corp. v. Ponsock*<sup>269</sup> fired a tenured employee just six months before his retirement benefits would have vested in order to evade payment of those benefits.<sup>270</sup> Like an insured, this employee had already performed most of his side of the bargain, having worked for nearly the entire period required for vesting of benefits.<sup>271</sup> But like an insurer, this employer had no real incentive to perform its side of the bargain by continuing the employment until retirement benefits had vested. The economic value of the employee's remaining services must have appeared small when compared to the financial loss that payment of retirement benefits would entail. Thus, the nature of this particular employment relationship created a strong economic incentive for the employer to discharge the employee in bad faith. Contract remedies could not have neutralized this incentive. Even if the employee won his case, the employer would only have paid the same retirement benefits in the form of expectation damages.

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265. *Foley v. Interactive Data Corp.*, 47 Cal. 3d 654, 693, 765 P.2d 373, 396, 254 Cal. Rptr. 211, 234 (1988).

266. *Wallis v. Superior Court*, 160 Cal. App. 3d 1009, 1117, 207 Cal. Rptr. 123, 128 (1984).

267. See FARNSWORTH, *supra* note 4, § 12.8, at 871.

268. See, e.g., *Rawlings v. Apodaca*, 726 P.2d 565, 575-76 (Ariz. 1986); *Wallis*, 160 Cal. App. 3d at 1117, 207 Cal. Rptr. at 128; *Arnold v. National County Mut. Fire Ins. Co.*, 725 S.W.2d 165, 167 (Tex. 1987).

269. 732 P.2d 1364 (Nev. 1987).

270. *Id.* at 1365.

271. *Id.* at 1366.

The *K Mart* court recognized that the employer had an incentive to breach, and that contract remedies were powerless to counteract that incentive. "If all a large corporate employer had to do was to pay contract damages," the court declared, "it would allow *and even encourage* dismissals of employees on the eve of retirement with virtual impunity."<sup>272</sup> Since contract damages did not provide an adequate deterrent, the court held that the employee could seek tort remedies for the bad faith breach.<sup>273</sup>

*Wallis v. Superior Court*<sup>274</sup> presented a similar problem. Before leaving his job, the employee extracted from his employer a promise to make monthly support payments until he could begin drawing pension benefits.<sup>275</sup> Three years after the employee left the company, the employer reneged on the obligation to make support payments.<sup>276</sup> At this point the former employee had already performed his part of the bargain by not competing after leaving the job. The employer, however, had little incentive to perform by continuing to make the monthly support payments.<sup>277</sup> Whatever value there might have been in maintaining the goodwill of a former employee, the high cost of the support payments outweighed it. Accordingly, this particular contractual relationship involved a strong economic incentive for the employer to terminate the support payments in bad faith. And, as the California Court of Appeal expressly recognized, contract remedies could not have eliminated this incentive; at its worst the employer would have been forced to pay the same support in the form of expectation damages.<sup>278</sup> "If [the employee] obtained a judgment against [the employer] for mere breach of contract, [the employer] would only have to pay what it owed anyway."<sup>279</sup> On this basis the court held that bad faith breach of the contract sounded in tort.<sup>280</sup>

Consistent with the foregoing cases, the Arizona Supreme Court has *denied* tort remedies where a contractual relationship did *not* involve any special incentive to breach. In *Oldenburger v. Del E. Webb Development Co.*,<sup>281</sup> consumer buyers entered into a contract with a development

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272. *Id.* at 1372 (emphasis added).

273. *Id.* at 1372-73.

274. 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984).

275. *Id.* at 1113, 207 Cal. Rptr. at 125.

276. *Id.*

277. *Id.* at 1117, 207 Cal. Rptr. at 127-28.

278. *Id.*

279. *Id.* at 1119, 207 Cal. Rptr. at 129.

280. *Id.* at 1116, 207 Cal. Rptr. at 127.

281. 765 P.2d 531 (Ariz. Ct. App. 1988).

company for the purchase of a residence under construction.<sup>282</sup> When the buyers insisted that they be allowed to install a nonstandard bathtub, the development company cancelled the sale.<sup>283</sup> The buyers sued, alleging a claim for tortious breach of the implied duty of good faith and fair dealing.<sup>284</sup> The trial court granted summary judgment in favor of the development company, and the buyers appealed.<sup>285</sup>

The Arizona Court of Appeals affirmed the judgment against the buyers on the bad faith tort claim.<sup>286</sup> Seeking to distinguish cases that had recognized the bad faith tort within the insurance context, the court noted that it was frequently in the economic interest of an insurance company to breach its contract.<sup>287</sup> Thus, tort remedies had been adopted in order to provide a substantial deterrent against breach of the insurance contract.<sup>288</sup> By contrast, the court continued, the consumers in the present case had not explained why tort remedies were necessary to deter home sellers from breaching their contracts.<sup>289</sup> No factors unique to the home construction industry had been identified that were not applicable to all consumer sales.<sup>290</sup>

In sum, early decisions demonstrated a concern that certain contracting parties—insurers in particular—had too much incentive to break their promises. Tort remedies countered these incentives and thus deterred promise breaking.

## 2. Implications of the early cases

What are the policy implications of these early bad faith tort decisions, with their emphasis upon the incentive that certain parties have to break their promises? According to Fried, the purpose of promise is to increase individual autonomy, and the moral obligation to keep promises is founded upon respect for the exercise of individual autonomy.<sup>291</sup> Viewed in light of his theory, the early bad faith tort decisions reflect concern for the institution of promise and its underlying value of individual autonomy.

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282. *Id.* at 532.

283. *Id.*

284. *Id.* at 533.

285. *Id.* at 531.

286. *Id.* at 536.

287. *Id.* at 535 (discussing *Rawlings v. Apodaca*, 726 P.2d 596 (Ariz. Ct. App. 1985)).

288. *Id.* (discussing *Rawlings v. Apodaca*, 726 P.2d 596 (Ariz. Ct. App. 1985)).

289. *Id.*

290. *Id.*

291. FRIED, *supra* note 254, at 16.



To explain this conclusion, consider what happens when a promisor breaches a contract in bad faith. As discussed above, the policy underlying traditional contract remedies is compensation, rather than compulsion.<sup>292</sup> The promisor need not perform its promise, but if it does not, it must make the promisee whole. Thus, the classic remedy for breach of contract is expectation damages, which seek to place the promisee in the same position as if the promisor had performed its promise.<sup>293</sup>

In a world where contract remedies provided perfect compensation for the promisee's loss upon breach, bad faith breach of contract might not pose a threat to the institution of promise. The possibility of breach would not cause a potential promisee to shy away from a profitable deal, since it would be satisfied with expectation damages as a true substitute for performance. Unfortunately, we do not live in such a world. Due to the limited nature of contract remedies, a promisee is often undercompensated: It cannot recover damages for economic loss that the promisor did not have reason to foresee as a probable result of breach when the contract was made.<sup>294</sup> Additionally, the promisee cannot collect damages for emotional distress unless the breach caused bodily harm or was of a kind particularly likely to result in serious emotional disturbance.<sup>295</sup> Perhaps most importantly, the promisee cannot recoup attorney's fees and court costs, even if it wins the case, unless the contract in issue provides otherwise.<sup>296</sup> Since expectation damages are *not* a true substitute for performance, the promisee *must* be able to depend upon the promisor to perform its promise. If it cannot, the promisee is less likely to enter into a contract with the promisor, and a profitable transaction may be lost.

Therefore, every bad faith breach of contract results in some incremental loss of confidence in the institution of contractual promise. Undoubtedly, the institution is strong enough to survive the occasional assault upon its integrity; however, pervasive bad faith breach would pose a more serious threat to the willingness of promisees to repose their faith in promisors. And, when prospective promisees become reluctant to enter upon courses of action that require a reliable commitment, individual autonomy is decreased for promisees and promisors alike.

Against this background the connection between the early bad faith decisions and individual autonomy is more clearly visible. Taking the

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292. See *supra* notes 16-19 and accompanying text.

293. See FARNSWORTH, *supra* note 4, § 12.8, at 871.

294. RESTATEMENT (SECOND) OF CONTRACTS § 351 (1979).

295. *Id.* § 353.

296. See 5 CORBIN, *supra* note 42, § 1037, at 225; Putz & Klippen, *supra* note 84, at 424.

insurance cases as an example, the very nature of the performance required under an insurance contract—the transfer of wealth from insurer to insured—guarantees that, *in every case*, the insurer has a strong incentive to breach its contract. Thus, there is a very real threat of epidemic breach within the insurance context. Unlike occasional breach of contract, such widespread breach could seriously undermine confidence in the promises of insurers. Consequently, the ability of individuals to freely order their affairs through the purchase of insurance contracts would be reduced. The autonomy of prospective insureds would also suffer, since they would have fewer opportunities to make profits by entering into insurance contracts. By countering the insurers' incentive to breach with extensive tort remedies, including punitive damages, the bad faith tort made the promises of insurers more reliable than they would otherwise have been, thereby encouraging the making of insurance contracts and increasing the autonomy of prospective insureds and insurers.

Going beyond the insurance context, cases such as *K Mart Corp. v. Ponsock*<sup>297</sup> and *Wallis v. Superior Court*<sup>298</sup> demonstrated that other contractual relationships could also create a strong incentive to breach. Generalizing from those cases, where one contracting party has already performed, and the benefits to be derived from maintaining its goodwill are minimal, the other party has an unusually strong incentive to maximize wealth by withholding its own performance. By neutralizing this incentive, tort remedies strengthen the institution of promise within such relationships and help to preserve the widest range of options for prospective promisors and promisees. Thus, these cases, too, reflected a concern for individual autonomy.

To some, this analysis of the early bad faith tort cases may seem counterintuitive. Some might characterize promise breaking not as a threat to individual freedom, but rather as the *exercise* of individual freedom: "[Along with] the celebrated freedom to make contracts, [comes] a considerable freedom to break them as well."<sup>299</sup> In that case, imposition of tort remedies for breach of contract would seem to restrict, rather than promote, individual autonomy. However, as Fried notes, "the mystery that surrounds increasing autonomy by providing means for restricting it" is a "pseudomystery."<sup>300</sup> If promises are not binding, they are not meaningful, and the options available to the individual are decreased.<sup>301</sup>

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297. 732 P.2d 1364 (Nev. 1987).

298. 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984).

299. Farnsworth, *supra* note 20, at 1147.

300. FRIED, *supra* note 254, at 14.

301. *See id.*

Thus, imposing tort remedies for breach of promise is consistent with respect for individual autonomy.

At this point Gilmore's theory may be critiqued from an interesting, new perspective. On the one hand, if we accept the premise that limited remedies are the heart and soul of classical contract theory, we must concede that the rise of the bad faith tort seemed—for a time—to validate Gilmore's thesis that contract was dead. On the other hand, the above analysis contradicts his theory as to *why* contract was dead. As I have shown, Gilmore believed that the death of contract reflected society's move *away* from nineteenth-century individualism, with its emphasis upon autonomy and freedom of decision.<sup>302</sup> But, to the extent the bad faith tort suggested that contract was dead, that "death" reflected a move *toward* individual freedom. By counteracting incentives that threatened to induce breach of contract in some contexts, tort remedies reinforced the ability of the individual to order his or her affairs through the institution of contractual promise. Thus, the rise of the bad faith tort confirmed individual freedom as an important cultural value.

### C. *Relationships Not Involving Incentive to Breach*

Whereas the early bad faith tort decisions stressed the strong economic incentive that insurers and certain other persons had to break their promises, later cases recognized that such incentive was not present in most contractual relationships. This realization hastened the death of the bad faith tort.

#### 1. The later cases

The *Foley v. Interactive Data Corp.*<sup>303</sup> case is representative. To support its holding that breach of an employment contract did not sound in tort, the California Supreme Court rushed to distinguish the employment relationship from that between insured and insurer. The insurer and insured are financially at odds, the court reasoned, since payment simply shifts money from the insurer to insured.<sup>304</sup> By contrast, the interests of the employer and employee are aligned, since it is to the employer's own economic benefit to retain good employees.<sup>305</sup> Accordingly, the need to place disincentives on an employer's conduct in addition to those already imposed by law did not rise to the level created by the conflicting inter-

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302. GILMORE, *supra* note 1, at 95.

303. 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211 (1988).

304. *Id.* at 693, 765 P.2d at 396, 254 Cal. Rptr. at 234.

305. *Id.*

ests of insurer and insured.<sup>306</sup> Thus, the California Supreme Court concluded that tort remedies were not necessary to combat a threat of widespread promise breaking within the employment context.<sup>307</sup>

Similarly, the need to combat promise breaking within the investment context was minimized in *Wholesale Electric Co. v. Shearson Lehman Bros.*<sup>308</sup> There, an investor filed a complaint for breach of fiduciary duty against a brokerage house that had invested and lost its funds.<sup>309</sup> The jury returned a verdict in favor of the investor on its claim for breach of fiduciary duty.<sup>310</sup> The investor then filed a second complaint for tortious breach of the duty of good faith and fair dealing, alleging that the brokerage house had refused to enter into meaningful discussions prior to the first suit, had intentionally made untrue statements, had wrongfully denied the existence of any agreement, had refused to make good faith settlement offers, and had destroyed evidence relevant to its breach of fiduciary duty claim.<sup>311</sup> The trial court dismissed the complaint for failure to state a valid cause of action.<sup>312</sup>

The California Court of Appeal affirmed, holding that the investor had not "alleg[ed] facts sufficient to show the special relationship necessary for tort damages for breach of the implied covenant."<sup>313</sup> This holding was based in part on the court's reasoning that the financial interests of the investor and brokerage house were not at odds; rather, it was in the brokerage house's financial interest to make money on its clients' accounts.<sup>314</sup> In other words, the relationship between the investor and brokerage house did not involve an inherent risk of promise breaking.

The Arizona Supreme Court sounded a similar note in *Burkons v. Titor Title Insurance Co.*<sup>315</sup> In that case, a development company contracted to purchase a parcel of Phoenix real estate from an unsophisticated seller for a small down payment, securing the balance of the purchase price with a note secured by a deed of trust.<sup>316</sup> The seller agreed to subordinate his purchase money deed of trust to a loan that he believed would be used to finance construction on the property.<sup>317</sup> Instead, the

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306. *Id.*

307. *Id.*, 765 P.2d at 396, 254 Cal. Rptr. at 234-35.

308. 221 Cal. App. 3d 617, 270 Cal. Rptr. 566 (1990).

309. *Id.* at 620, 270 Cal. Rptr. at 567.

310. *Id.*

311. *Id.* at 621, 270 Cal. Rptr. at 568.

312. *See id.*

313. *Id.* at 625, 270 Cal. Rptr. at 571.

314. *Id.* at 623-24, 270 Cal. Rptr. at 570.

315. 813 P.2d 710 (Ariz. 1991).

316. *Id.* at 712-13.

317. *Id.* at 713.

buyer used part of the loan to pay the down payment to the seller and pocketed the remainder.<sup>318</sup> Unfortunately, the escrow agent involved in the transaction facilitated the fraud by disbursing the loan to the buyer without restriction.<sup>319</sup> The buyer did not improve the property and defaulted on the note, leaving the seller holding a subordinate deed of trust on property, which was not worth enough to cover both the "construction" loan and the balance of the purchase price.<sup>320</sup> The seller sued his escrow agent,<sup>321</sup> alleging that the agent had breached the escrow contract by subordinating his deed of trust to a loan that was not used for construction, contrary to the escrow instructions.<sup>322</sup> The seller also asserted a bad faith tort claim, complaining that the escrow agent had refused to restore his deed of trust to first position by acquiring and forgiving the other loan.<sup>323</sup> In effect, this amounted to a claim that the escrow agent was liable in tort because of failure to pay the seller his contractual damages on demand.<sup>324</sup> The trial court dismissed the bad faith count for failure to state a claim and awarded summary judgment to the escrow agent on the remaining counts.<sup>325</sup> After the court of appeals reversed on all counts, the escrow agent appealed.<sup>326</sup>

The Arizona Supreme Court agreed with the court of appeals that summary judgment was inappropriate on the breach of contract claim. The court held that there was a genuine issue of material fact as to whether the parties had manifested intent that the subordination agreement be made conditional upon use of the loan proceeds for construction.<sup>327</sup> However, the supreme court agreed with the trial court that the seller had failed to state a valid bad faith tort claim.<sup>328</sup> The court opined that a party who breached a contract had no duty to accede to the other party's demand for payment of contract damages.<sup>329</sup> Moreover, tort damages were most often allowed in situations where the rule restricting recovery to contract damages would promote breach of the contract

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318. *Id.*

319. *Id.* at 712-13.

320. *See id.* at 713 & n.5 (discussing fact that property was "over-encumbered").

321. The record does not disclose whether the seller collected anything on the buyer's note or took any action to foreclose his purchase money deed of trust. *Id.* at 713.

322. *Id.* at 713-14.

323. *Id.* at 720.

324. *Id.*

325. *Id.* at 714.

326. *Id.*

327. *Id.* at 716.

328. *Id.* at 721.

329. *Id.* at 720.

rather than performance.<sup>330</sup> Here, the seller had not alleged that the contract measure of damages was insufficient to deter other escrow agents from breaching their duties.<sup>331</sup> In other words, the court rejected tort remedies in part because such remedies were unnecessary to protect the institution of promise; escrow agents had no special incentive to breach their agreements.

In sum, arguments that promisors had strong incentives to break their promises fell upon stony ground in later cases. The courts did not recognize any new contexts or relationships in which the incentive to breach justified imposition of tort remedies as a deterrent. Consequently, further extension of the bad faith tort beyond the insurance context was curtailed.

## 2. Implications of the later cases

Once again, a conundrum is apparent: What do these later bad faith tort cases represent, with their rejection of the bad faith tort?

One possible conclusion is that the early and later cases involved fundamentally different contractual relationships. Under this view early cases addressed unusual relationships that created particularly strong incentives to breach. For example, an insurer has a strong economic incentive to breach, creating a risk of epidemic promise breaking within an entire category of contract. Similarly, the early cases of *K Mart Corp. v. Ponsock*<sup>332</sup> and *Wallis v. Superior Court*<sup>333</sup> involved one-sided relationships that gave one party a strong incentive to breach. By contrast, the later cases addressed ordinary commercial relationships, which did not create such a powerful incentive to breach rather than perform. Absent any risk of widespread promise breaking, the later cases would have had no reason to adopt tort remedies in order to protect the institution of promise and its underlying value of individual autonomy.

At the same time, the later cases, which rejected tort remedies for breach of contract, might reflect decreased concern regarding promise breaking. In other words, because tort remedies would have strongly encouraged contract parties to keep their promises, refusal to award tort remedies could suggest relative indifference as to whether those promises were kept. Moreover, the moral obligation to keep promises is founded upon respect for individual autonomy. Thus, any such indifference to-

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330. *Id.*

331. *Id.* at 721.

332. 732 P.2d 1364 (Nev. 1987); see *supra* note 167 and accompanying text.

333. 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984); see *supra* note 84 and accompanying text.

wards promise breaking could indicate that individual autonomy, though important, has been outweighed by policy considerations supporting the traditional, limited remedies for breach of contract.<sup>334</sup>

In either event, my analysis demonstrates that contract is alive and well. By embracing traditional, limited remedies for breach of contract, the later cases reaffirmed the very core of classical contract theory. Interestingly, however, this return to traditional remedies does not reflect a return to individualism, as Gilmore might have surmised.<sup>335</sup> Rather, the return to traditional remedies reflects a return to some other policy considerations that have yet to be identified.

#### IV. EFFICIENT BREACH AND ECONOMIC GROWTH

So far, my analysis has emphasized the policy implications of the rise of the bad faith tort. The next and final task is to identify the policy implications of the death of the tort and the return of traditional, limited contract remedies.

##### A. *The Theory of Efficient Breach*

As noted above, the policy underlying traditional contract remedies is compensation, rather than compulsion. Through expectation damages the law seeks to place the promisee in the same position it would have enjoyed if the promisor had performed the promise.<sup>336</sup> Why should the common law choose expectation damages as the classic, but limited, remedy for breach of contract? One popular explanation is based upon the notion of efficient breach.<sup>337</sup> Economists use several different definitions of efficiency, but for my limited purposes here, efficiency can be defined as "pareto superiority." A voluntary transaction is pareto superior when it makes "at least one person in the world better off and no one worse off."<sup>338</sup>

A hypothetical example illustrates the concept of efficient breach. Suppose *A* promises to sell ten widgets to *B* at a price of \$300 per widget, for a total of \$3000. Later, *C* offers to purchase the same ten widgets at a price of \$400 per widget, for a total of \$4000. *A* knows that *B* can purchase substitute widgets from another seller at a price of \$325 per widget, for a total of \$3250. Accordingly, *A* deliberately breaches the

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334. See *infra* part IV.

335. See GILMORE, *supra* note 1, at 95-96.

336. See FARNSWORTH, *supra* note 4, § 12.8, at 871-78.

337. See generally RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* (4th ed. 1992) (arguing that economics is powerful tool for analyzing legal questions).

338. *Id.* at 12.

contract with *B* and sells the widgets to *C*. Then, out of the additional \$1000 profit earned on the deal with *C*, *A* pays \$250 in expectation damages to *B*.

This breach is efficient because it is pareto superior. *A*, who has earned a net additional profit of \$750, is better off; *C*, who has the widgets it wanted, is better off; and *B*, who has been paid \$250 in expectation damages, is no worse off since those damages place *B* in the same position it would have been in had *A* performed the original promise.<sup>339</sup>

Reasoning that society benefits when its resources are allocated efficiently, some scholars have argued that efficient breach of contract is desirable and should be encouraged.<sup>340</sup> In their view expectation damages are the ideal remedy for breach of contract, since they permit efficient breach to take place.<sup>341</sup> Thus, if a promisor must pay only expectation damages, it will breach whenever it can place the promisee in the same position it would have enjoyed upon performance *and* still make a profit—that is, whenever breach is efficient.<sup>342</sup> By contrast, these scholars believe that punitive damages are an undesirable remedy for breach of contract because they would have the effect of discouraging efficient breach.<sup>343</sup> To explain why, reconsider the widget hypothetical. Breach of the original contract with *B* and sale of the widgets to *C* is efficient because *A* and *C* are better off, and *B* is no worse off once it recovers expectation damages. But *A* would hesitate to commit this efficient breach if it knew that *B* could recover not only \$250 in expectation damages, but also some potentially enormous punitive damage award.

However elegant in theory, the efficient breach theory cannot justify every breach of contract in practice. Too often, expectation damages leave the promisee undercompensated. As noted above, the promisee can recover damages for economic loss only if its loss was foreseeable when the contract was made.<sup>344</sup> The promisee cannot collect damages for emotional distress<sup>345</sup> or recoup attorney's fees and court costs, even if it wins the case.<sup>346</sup> Thus, promisees who cannot afford to pay their own attorney's fees and court costs may not sue at all. To the extent promis-

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339. See *id.* at 107.

340. See, e.g., Peter Linzer, *On the Amoralty of Contract Remedies*, 81 COLUM. L. REV. 111 (1981).

341. See, e.g., POSNER, *supra* note 337, at 107-10; Robert L. Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 284 (1970).

342. See Birmingham, *supra* note 341, at 284; Linzer, *supra* note 340, at 114-15.

343. See POSNER, *supra* note 337, at 116; Birmingham, *supra* note 341, at 284.

344. See RESTATEMENT (SECOND) OF CONTRACTS § 351 (1979).

345. See *id.* § 353.

346. See 5 CORBIN, *supra* note 42, § 1037; Putz & Klippen, *supra* note 84, at 424.



ees sue and are undercompensated—or fail to sue altogether—promisors are free to commit *inefficient* breaches that cannot be justified in terms of efficient allocation of resources.<sup>347</sup>

## B. Recognizing the Problem of Inefficient Breach

### 1. The early cases

Against this background the bad faith tort can be viewed in a different light. The insurance cases that gave birth to the tort are a logical starting point for my analysis. Those cases involved insurers who, after taking premiums from their insureds, refused in bad faith to perform their obligations under their insurance contracts.<sup>348</sup> Were these breaches of contract efficient? Not at all. As Professor Thomas Diamond has explained:

The [insurance] company does not breach because it has discovered an alternative allocation of resources, the gains of which exceed the promisee's expected losses. When the contractual obligation breached is one to pay money, damages for the breach must at least equal the money that has not been paid. The insurance company's breach results in a gain to the company only if it is not required to pay the damages caused by breach. Its gains are exclusively at the promisee's expense.<sup>349</sup>

Thus, according to Diamond, "perhaps the most cogent explanation of why the tort of bad faith breach ever developed is that tort sanctions were essential to prevent such [inefficient] breaches by insurance companies."<sup>350</sup>

Unlike Diamond, the courts have not *expressly* cited inefficient breach as the reason for granting tort remedies within the insurance context. Nevertheless, the reasons courts *have* given for awarding tort remedies suggest that inefficient breach is an underlying concern. For example, the courts have asserted that ordinary contract remedies are inadequate to protect the rights of the insured because they offer no motivation whatsoever for the insurer not to breach:

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347. See Birmingham, *supra* note 341, at 285; Thomas A. Diamond, *The Tort of Bad Faith Breach of Contract: When, If at All, Should It Be Extended Beyond Insurance Transactions?*, 64 MARQ. L. REV. 425, 440-42 (1981); Putz & Klippen, *supra* note 84, at 431-32.

348. See Pennington, *supra* note 253, at 51; *supra* note 21 and accompanying text.

349. Diamond, *supra* note 347, at 446 (footnote omitted); see also Pennington, *supra* note 253, at 53-54 (arguing courts award punitive damages against insurers in effort to deter inefficient breach).

350. Diamond, *supra* note 347, at 446.

If the only damages an insurer will have to pay upon a judgment of breach are the amounts that it would have owed under the policy plus interest, it has every interest in retaining the money, earning the higher rates of interest on the outside market, and hoping eventually to force the insured into a settlement for less than the policy amount.<sup>351</sup>

This passage describes an inefficient breach since the insurer is seeking to achieve gains at the expense of the insured. Thus, the passage could be read as saying that contract remedies are inadequate because they offer no motivation whatsoever for the insurer not to commit an *inefficient* breach.

The courts have also awarded tort remedies on the rationale that contract damages do not make the insured whole, reasoning that “[m]oney damages paid pursuant to a judgment years after the insurer has initially reneged on payment do not remedy the harm suffered by the insured, namely the immediate inability to support oneself and its attendant horrors.”<sup>352</sup> As noted above, to the extent contract damages undercompensate the promisee, the promisor is free to commit inefficient breach.<sup>353</sup> Thus, while this reasoning emphasizes the vulnerability of the insured, it also implicitly recognizes that limited contract remedies allow insurers to commit inefficient breach.

Taking the above reasoning a step further, Diamond has argued that the bad faith tort should not be limited to the insurance context.<sup>354</sup> In his view, any willful breach induced by anticipated gains that would not exceed the promisee’s losses is unjust, promotes no social goals, and damages the fabric of societal integrity and commercial stability.<sup>355</sup> Consequently, willful breach should be regarded as tortious whenever the breaching party could not, at the time of breach, reasonably have expected the breach to be economically efficient.<sup>356</sup>

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351. *Wallis v. Superior Court*, 160 Cal. App. 3d 1109, 1117, 207 Cal. Rptr. 123, 128 (1984); *accord* *Rawlings v. Apodaca*, 726 P.2d 565, 575-76 (Ariz. 1986); *Arnold v. National County Mut. Fire Ins. Co.*, 725 S.W.2d 165, 167 (Tex. 1987), *modified*, *Murray v. San Jacinto Agency, Inc.*, 800 S.W.2d 826 (Tex. 1990).

352. *Wallis*, 160 Cal. App. 3d at 1118, 207 Cal. Rptr. at 128.

353. *See supra* part IV.A.

354. *Diamond*, *supra* note 347, at 436.

355. *Id.* at 438.

356. *Id.* at 444, 448; *cf.* John A. Seibert, Jr., *Punitive and Nonpecuniary Damages in Actions Based upon Contract: Toward Achieving the Objective of Full Compensation*, 33 UCLA L. REV. 1565, 1659-60 (1986) (arguing that punitive damages should be awarded against intentionally breaching party in order to provide full compensation to victim of breach, regardless of whether breach is efficient).

Diamond penned this theory in 1981, when the bad faith tort was just beginning to move beyond the insurance context. The Montana Supreme Court relied upon Diamond's theory in *Nicholson v. United Pacific Insurance*.<sup>357</sup> Quoting Diamond, the Montana Supreme Court conceded that certain intentional breaches should be encouraged: "Permitting parties to breach their contracts promotes an efficient economy, at least when the gains from the breach exceed the expected pecuniary injuries of the promisee."<sup>358</sup> However, the court continued, each party had a justifiable expectation that the other would act reasonably, *whether performing or breaching*.<sup>359</sup> Whenever one party frustrated this justifiable expectation by acting arbitrarily, capriciously, or unreasonably, the other could assert a bad faith tort claim.<sup>360</sup> Thus, *Nicholson* implied that tort remedies were appropriate whenever a party acted unreasonably by committing an inefficient breach.<sup>361</sup>

*Wallis v. Superior Court*,<sup>362</sup> another case extending the bad faith tort beyond the insurance context, also shows a heightened sensitivity to the problem of inefficient breach. Recall that *Wallis* involved a contract made just before termination of employment; the employer promised to make monthly support payments until the employee reached retirement age, while the employee promised to refrain from competing with the employer's business.<sup>363</sup> When the employer's business took a turn for the worse, it stopped making payments and the employee sued for tortious breach of contract.<sup>364</sup>

Holding that the employee had stated a valid cause of action, the California Court of Appeal reasoned that ordinary contract damages did not discourage an employer from breaching; even if the employee won his case, the employer would only have to pay what it owed anyway.<sup>365</sup> In other words, contract damages offered no incentive for the employer not to commit an *inefficient* breach, seeking only to enrich itself at the

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357. 710 P.2d 1342 (Mont. 1985).

358. *Id.* at 1348 (quoting Diamond, *supra* note 347, at 453).

359. *Id.*

360. *Id.*

361. The Montana Supreme Court confirmed this interpretation of *Nicholson* in *Dunfee v. Baskin-Robbins, Inc.*, 720 P.2d 1148 (Mont. 1986). There, the court explained that *Nicholson* distinguished legitimate, efficient breaches actionable in contract from unreasonable breaches actionable in tort. *Id.* at 1153. The *Dunfee* court went on to uphold a jury verdict for tortious breach of the duty of good faith against a franchisor that had unreasonably refused to permit its franchisee to move an ice cream store to a more desirable location. *Id.*

362. 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984).

363. *Id.* at 1113, 207 Cal. Rptr. at 125.

364. *Id.*

365. *Id.* at 1119, 207 Cal. Rptr. at 129.

employee's expense by terminating the promised payments. Moreover, the employee's immediate precarious financial position due to termination of payments could not be remedied by a lump-sum payment received several years later.<sup>366</sup> The employer was free to commit an inefficient breach because limited contract remedies would leave the employee undercompensated. Therefore, tort remedies were necessary in order to deter inefficient breach.

Finally, the award of tort remedies in *Seaman's Direct Buying Service v. Standard Oil Co.*<sup>367</sup> can be explained in terms of inefficient breach. Standard had entered into a contract to provide a ship supply dealer named Seaman's with its fuel requirements.<sup>368</sup> Shortly thereafter, an oil shortage caused a sharp increase in fuel prices, and the federal government issued regulations requiring suppliers to continue providing fuel to existing customers.<sup>369</sup> In an effort to escape its obligations, Standard flatly refused to acknowledge its contract with Seaman's.<sup>370</sup>

The California Supreme Court held that a party could incur tort remedies when, in addition to breaching the contract, it sought to shield itself from liability for breach of contract by denying, in bad faith and without probable cause, that the contract existed.<sup>371</sup> In support the court noted that a contracting party would be subject to tort liability—including punitive damages—if it coerced the other party to pay more than was due under the contract through the threat of a spurious lawsuit.<sup>372</sup> "There is little difference . . . between a contracting party obtaining excess payment in such manner," the court continued, "and a contracting party seeking to avoid all liability on a meritorious contract claim by adopting a 'stonewall' position . . . without probable cause and with no belief in the existence of a defense. Such conduct goes beyond the mere breach of contract. It offends accepted notions of business ethics."<sup>373</sup> In such a situation, the court concluded, tort remedies were not likely to upset the parties' reasonable expectations.<sup>374</sup>

This passage evokes, without ever directly mentioning, the problem of inefficient breach. The court painted a vivid picture of a contracting party who, by breaching the contract and then evading *all* liability for

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366. *Id.*

367. 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984).

368. *Id.* at 760, 686 P.2d at 1160, 206 Cal. Rptr. at 356.

369. *Id.* at 761, 686 P.2d at 1161, 206 Cal. Rptr. at 357.

370. *Id.*, 686 P.2d at 1161-62, 206 Cal. Rptr. at 357-58.

371. *Id.* at 769, 686 P.2d at 1167, 206 Cal. Rptr. at 363.

372. *Id.*

373. *Id.* at 769-70, 686 P.2d at 1167, 206 Cal. Rptr. at 363.

374. *Id.* at 770, 686 P.2d at 1167, 206 Cal. Rptr. at 363.

expectation damages in bad faith, seeks to gain solely at the expense of the other party. Confronted with this conduct, which smacks of inefficient breach, the court responded by imposing tort remedies as a deterrent. The court's final comment is particularly revealing. The reasonable expectations of a promisor include the right to substitute efficient breach for performance upon payment of expectation damages.<sup>375</sup> Thus, the imposition of tort remedies for breach of contract would conflict with the reasonable expectations of the promisor *unless* it was substituting *inefficient* breach for performance.

Summarizing the analysis so far, the early bad faith tort cases showed increased sensitivity to the problem of inefficient breach. The courts began by granting tort remedies in the insurance context, relying on factors indicating that contract remedies were inadequate to deter inefficient breach. In extending the tort remedies to other contexts, subsequent cases also stressed the need to deter inefficient breach.

## 2. Implications of the early cases

What inferences can be drawn from these early bad faith tort decisions? Did they indicate disenchantment with the efficient breach theory as such? Not really. Rather, the early cases simply acknowledged that efficient allocation of resources, while a worthy objective, could not justify breaches of contract that were *inefficient*. Freed from the shadow of efficient breach theory, policies that supported contract performance, such as altruism and individual freedom, took on a new luster and prominence. Tort remedies were adopted to deter inefficient breaches of contract, which threatened *both* altruism *and* individual freedom, without providing any compensating benefit in the form of efficient allocation of resources.

Presumably, Gilmore would have been delighted by this turn of events, for it supported his thesis. Gilmore believed that narrow contract remedies were a key element of classical contract theory.<sup>376</sup> In his view the broadening of remedies for breach of contract during the twentieth century signaled the demise of classical theory.<sup>377</sup> For a time the early bad faith tort cases seemed to prove Gilmore's point. Their substitution of broad tort remedies for classical contract remedies hinted that contract was in decline. Moreover, by recognizing that classical contract

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375. See *Nicholson v. United Pac. Ins.*, 710 P.2d 1342, 1348 (Mont. 1985); see also HOLMES, *supra* note 19, at 301 (stating that promisor is free to breach contract upon payment of damages).

376. GILMORE, *supra* note 1, at 14.

377. *Id.* at 83-84.

remedies permitted not only efficient, but also *inefficient* breach, the early cases cast doubt upon the primary policy rationale for keeping such remedies limited.

### C. *Economic Values Support Limited Contract Remedies*

#### 1. The later cases

The impression that contract was teetering on the edge of destruction was short-lived, however. By the late 1980s most courts refused to award tort remedies for breach of contract, even though they continued to implicitly acknowledge the problem of inefficient breach.

Once again, the *Foley v. Interactive Data Corp.*<sup>378</sup> case is instructive. Having determined that there was no special relationship between employer and employee comparable to that between insurer and insured,<sup>379</sup> the *Foley* court went on to consider other arguments advanced in favor of extending the bad faith tort to the employment context.<sup>380</sup> The court noted that "[t]he most frequently cited reason for the move to extend tort remedies . . . is the perception that traditional contract remedies are inadequate to compensate for certain breaches."<sup>381</sup> As discussed, when contract remedies are inadequate to make promisees whole, promisors are free to commit breaches that cannot be justified in terms of efficient allocation of resources.<sup>382</sup> Thus, the *Foley* court implicitly recognized the risk of inefficient breach.

However, the *Foley* court questioned whether the problem of inadequate compensation could or should be resolved by departing from established principles of contract law.<sup>383</sup> Reasoning that the answer could alter the nature of employment, the cost of products and services, and the availability of jobs, the court concluded that the decision was best left to the legislature.<sup>384</sup> Thus, unlike earlier courts, the *Foley* court did not accept inadequate contract remedies, with their undercurrent of inefficient breach, as a license to grant tort remedies.

The *Copesky v. Superior Court*<sup>385</sup> decision, which rejected tort remedies for breach of a commercial deposit contract,<sup>386</sup> employed similar reasoning. Working with the third *Wallis* factor, the California Court of

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378. 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211 (1988).

379. *Id.* at 690-93, 765 P.2d at 394-96, 254 Cal. Rptr. at 232-35.

380. *Id.* at 693-94, 765 P.2d at 396-97, 254 Cal. Rptr. at 235.

381. *Id.* at 694, 765 P.2d at 397, 254 Cal. Rptr. at 235.

382. *See supra* notes 336-47 and accompanying text.

383. *Foley*, 47 Cal. 3d at 694, 765 P.2d at 397, 254 Cal. Rptr. at 235.

384. *Id.*

385. 229 Cal. App. 3d 678, 280 Cal. Rptr. 338 (1991).

386. *Id.* at 694, 280 Cal. Rptr. at 348-49.

Appeal conceded that the depositor's recovery against the bank for cashing a forged check might be inadequate since he could not recover attorney's fees and other court costs.<sup>387</sup> But this problem was endemic to *all* commercial transactions; without recovery of attorney's fees and court costs, *no one* involved in commercial litigation could be made completely whole.<sup>388</sup> "*Wallis* was not talking about this defect in our jurisprudential system," the court opined.<sup>389</sup> "[I]t had to do instead with the peculiar loss associated with denial of payment of insurance proceeds, or, as in *Wallis*, the peremptory interruption of monthly termination payments to an aged, retired employee."<sup>390</sup> Again, by recognizing the systemic inadequacy of contract damages, the court impliedly acknowledged the possibility of inefficient breach. Nevertheless, the court refused to consider whether tort remedies might be an appropriate means of deterring breaches of contract that could not be justified on efficiency grounds.<sup>391</sup>

In *Story v. City of Bozeman*,<sup>392</sup> the Montana Supreme Court directly addressed a challenge to efficient breach theory, conceding that "efficient breach is rarely efficient; the winning party must pay the cost of recovering contract damages."<sup>393</sup> Nevertheless, the court continued, this problem did not support tort damages.<sup>394</sup> Thus, with one stroke of its pen, the Montana Supreme Court repudiated its earlier holding in *Nicholson v. United Pacific Insurance*<sup>395</sup> that tort remedies were appropriate whenever a party acted unreasonably by committing an inefficient breach.<sup>396</sup>

Finally, in two other post-*Foley* decisions, the California Court of Appeal refused to even acknowledge the possibility that inadequate damages might lead to inefficient breach. In *Careau & Co. v. Security Pacific Business Credit*,<sup>397</sup> the court held that breach of a commercial loan contract did not sound in tort, stating that ordinary contract damages were adequate to make the prospective borrowers whole.<sup>398</sup> And in *Martin v. U-Haul Co.*,<sup>399</sup> the court held that termination of an equipment dealership contract did not sound in tort, declaring that expectation damages

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387. *Id.* at 691, 280 Cal. Rptr. at 347.

388. *Id.*

389. *Id.*

390. *Id.* at 691-92, 280 Cal. Rptr. at 347.

391. *Id.* at 694, 280 Cal. Rptr. at 348-49.

392. 791 P.2d 767 (Mont. 1990).

393. *Id.* at 774.

394. *Id.*

395. 710 P.2d 1342 (Mont. 1985).

396. *Id.* at 1348.

397. 222 Cal. App. 3d 1371, 272 Cal. Rptr. 387 (1990).

398. *Id.*

399. 204 Cal. App. 3d 396, 251 Cal. Rptr. 17 (1988).

would fully compensate the dealer for loss of income upon termination.<sup>400</sup>

## 2. Implications of the later cases

What is to be learned from the later cases, with their refusal to adopt tort remedies as a means of deterring inefficient breach?

One possible inference can be eliminated at the outset. Several scholars have suggested that, rather than award tort remedies as a means of providing adequate compensation for breach of contract, the courts should simply revise contract remedies to make them adequate—whether by allowing the prevailing party to recover his or her attorney's fees and court costs,<sup>401</sup> or by relaxing traditional limitations upon recovery of contract damages as necessary to make an injured party whole.<sup>402</sup> Whatever the merits of these proposals,<sup>403</sup> most courts have not adopted them. Instead, as in the *Foley*<sup>404</sup> and *Copesky*<sup>405</sup> decisions, the courts simply have accepted the fact that traditional contract damages provide inadequate compensation.<sup>406</sup> Therefore, refusal to award tort remedies does not imply that contract remedies now provide adequate compensation.

Another, more credible inference is that the early cases addressed unusual contractual relationships in which most breaches of contract were inefficient. As discussed above, an insurer and insured are at financial odds because payment simply shifts money from the insurer to the insured.<sup>407</sup> Thus, *the very nature of the insurance relationship gives the insurer an incentive to commit inefficient breach*, retaining the insurance proceeds in an effort to profit at the expense of the insured. Similarly, the

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400. *Id.* at 415, 251 Cal. Rptr. at 27-28.

401. See Putz & Klippen, *supra* note 84, at 499; Chutorian, *supra* note 84, at 404.

402. See Traynor, *supra* note 84, at 12-14; Chutorian, *supra* note 84, at 403; Scallen, *supra* note 83, at 1189-91.

403. Even adequate contract remedies might not be enough to deter insurers and other persons who have strong incentives to commit inefficient breach. Some victims of breach might not pursue claims to judgment, or could—for whatever reason—be reluctant to sue. Thus, insurers would still have an incentive to commit inefficient breach on a grand scale, in the hopes that only some plaintiffs would persist long enough to collect their adequate compensation.

404. 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211 (1988).

405. 229 Cal. App. 3d 678, 280 Cal. Rptr. 338 (1991).

406. Additionally, in *Story*, the Montana Supreme Court suggested that the best solution to the problem of inadequate remedies was for parties to include attorney's fees provisions in their contracts. See *Story*, 791 P.2d at 774.

407. *Foley*, 47 Cal. 3d at 693, 765 P.2d at 396, 254 Cal. Rptr. at 234; see *supra* note 138 and accompanying text.



employer in *Wallis*<sup>408</sup> had little to gain by continuing to make support payments to a *former* employee. The employer deliberately terminated the payments, committing an inefficient breach in an attempt to gain at the employee's expense. Thus, perhaps these early decisions simply reflected the fact that efficient allocation of resources was an inapplicable policy within certain relationships that tended to yield mostly inefficient breaches of contract.

By contrast, later decisions refusing to adopt tort remedies may reflect the fact that efficient allocation of resources remains a realistic policy objective within most contractual relationships. Although the inadequacy of traditional contract remedies might induce the occasional inefficient breach, efficient breach is also a possibility. Thus, the imposition of tort remedies, designed to deter and punish inefficient breach, might have the undesirable side-effect of discouraging efficient breach. By embracing limited contract remedies despite their inadequacy, the later cases suggest that efficient allocation of resources remains an important policy goal, worth pursuing at the expense of the occasional inefficient breach.

The later decisions also reveal the importance of a related, but distinct, policy goal: economic growth. Limited contract remedies promote economic growth by reducing and defining the financial risks that entrepreneurs must face.<sup>409</sup> Consider, for example, the rule limiting recovery for breach of contract to loss that the promisor has reason to foresee as a probable result of breach when the contract is made.<sup>410</sup> This rule has its source in the hoary old case of *Hadley v. Baxendale*,<sup>411</sup> decided in 1854. Commenting upon the cultural origins of the rule, Friedman has noted:

From the point of view of those in the position of the defendant in *Hadley*, the rule of the case was a risk-limiting rule, and therefore a way of standardizing costs and rationalizing enterprise. Like some of the nineteenth-century tort rules, it protected industry and commerce from ruinous losses; like abstraction in general, it won acceptance not simply because of its ideological appeal but also because it seemed to further a greater goal—economic growth and the encouragement of industry.<sup>412</sup>

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408. 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984).

409. See Chutorian, *supra* note 84, at 391.

410. See RESTATEMENT (SECOND) OF CONTRACTS § 351 (1979).

411. 156 Eng. Rep. 145 (Ex. 1854).

412. LAWRENCE M. FRIEDMAN, CONTRACT LAW IN AMERICA 126 (1965).

Similarly, eliminating the specter of open-ended punitive damage awards for bad faith breach of contract helps to reduce and standardize the costs associated with contracts, thereby promoting commerce and economic growth.<sup>413</sup> Significantly, the *Foley*<sup>414</sup> court expressly adopted this rationale for its holding that tort remedies should not be made available in the employment context.

[S]everal factors combine to persuade us that in the absence of legislative direction to the contrary contractual remedies should remain the sole available relief for breaches of the implied covenant of good faith and fair dealing in the employment context. Initially, predictability of the consequences of actions related to employment contracts is important to commercial stability. In order to achieve such stability, it is also important that employers not be unduly deprived of discretion to dismiss an employee by the fear that doing so will give rise to potential tort recovery in every case.<sup>415</sup>

Thus, when the condition of contract is measured by the later cases, the diagnosis is robust health, rather than the death Gilmore prematurely proclaimed. Offered the opportunity to replace classical contract remedies with more expansive tort remedies, the courts have refused to do so in all but a few unusual contexts. Moreover, the later cases reflect the continued significance of policies supporting limited contract remedies. Efficient allocation of resources remains an important goal; and economic growth supports limited contract remedies today, just as it supported the development of such remedies during the nineteenth century.

## V. CONCLUSION

This review of the tumultuous history of the bad faith tort has shown that Gilmore spoke too soon: Contract is alive and well. Admittedly, had the bad faith tort ever gained widespread acceptance, the substitution of expansive tort remedies for the narrow remedies traditionally available for breach of contract would have stabbed classical contract theory through the heart. But the menacing tort turned out to be a paper tiger. Never experiencing widespread success, the tort ultimately was rejected, even by original enthusiasts such as California and Montana. The courts' fervent reaffirmation of the very remedies that Gilmore character-

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413. See Traynor, *supra* note 84, at 13.

414. 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211 (1988).

415. *Id.* at 696, 765 P.2d at 398-99, 254 Cal. Rptr. at 236-37 (citation omitted).

ized as the core of classical contract theory demonstrates the continued vitality of contract.

This study of the history of the bad faith tort has also shown that contract stands on a firm policy foundation. As discussed, the rise of the tort was supported by the development of a quasi-fiduciary model of contract and the implicit recognition of a moral obligation to keep promises. Thus, contrary to Gilmore's theory, both social responsibility *and* individual freedom supported the temporary move away from contract towards tort. Ultimately, however, the courts reaffirmed traditional, limited contract remedies, indicating the primary importance of efficient allocation of resources and economic growth. When judged against altruism and individual freedom, these two economic goals apparently weigh more heavily in the balance.<sup>416</sup> Today, as before, "[t]he core of concern of the law of contract [is] with the market."<sup>417</sup>

Despite his errors, Gilmore cannot be dismissed entirely, for even while proclaiming the death of contract, he was hedging his bets. Reflecting upon the fact that there are alternating rhythms of classicism and romanticism in literature and the arts, he mused:

Perhaps we should admit the possibility of such alternating rhythms in the process of the law. We have witnessed the dismantling of the formal system of the classical theorists. We have gone through our romantic agony—an experience peculiarly unsettling to people intellectually trained and conditioned as lawyers are. It may be that, in this centennial year, some new Langdell is already waiting in the wings to summon us back to the paths of righteousness, discipline, order, and well-articulated theory. Contract is dead—but who knows what unlikely resurrection the Easter-tide may bring?<sup>418</sup>

Perhaps the dramatic fall of the bad faith tort is a harbinger of the unlikely resurrection that Gilmore foresaw. More likely, to paraphrase the irreverent words of America's favorite author and humorist, reports of the death of contract simply have been greatly exaggerated.<sup>419</sup>

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416. See SHEPHERD, *supra* note 159, at 122-23; Michael Bayles, *Introduction: The Purposes of Contract Law*, 17 VAL. U. L. REV. 613, 620 (1983).

417. FRIEDMAN, *supra* note 412, at 184.

418. GILMORE, *supra* note 1, at 103.

419. Towards the end of his long life, Mark Twain heard news reports of his own death. Characteristically, he responded with a witticism, cabling back that reports of his death had been greatly exaggerated. See LOUIS J. BUDD, *OUR MARK TWAIN: THE MAKING OF HIS PUBLIC PERSONALITY* 130 (1983).